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ABSTRACT

Through its role in administering the laws pertaining to tax-exempt status, the Internal Revenue Service (IRS) is involved in regulating the activities of those organizations that claim such a special position. The interplay between the federal tax system and private colleges will intensify as the demands increase for additional financial support from traditional sources and new sources of revenue are sought. Of tantamount importance is that college administrators be aware of how the current federal tax system applies to specific operations of private colleges. The historical common law roots of the relationship between education and the state are examined, and legal issues, definitions, and court rulings are discussed. The charitable deduction and the responsibility of the private college are discussed in detail. (Author/MSE)

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Private Colleges: The Federal Tax System And Its Impact

Gerald P. Moran

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***Private Colleges:
The Federal
Tax System
And Its Impact***

Gerald P. Moran

College of Law

The University of Toledo

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The University of Toledo**

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FOREWORD

A considerable amount of attention has been devoted recently to the financial condition of private higher education. Although there is conflicting evidence about the true nature, extent, and seriousness of the problem, there is widespread agreement that the position of the independent sector today is vulnerable to a number of pressures that ultimately affect its long-run security and viability. Among these pressures are the contracting pool of traditional students, which has resulted in greater competition with public institutions for clientele, the shift in student-consumer interests away from liberal arts to vocational preparation, and inflation, which has widened the tuition dollar gap between private and public higher education and forced private institutions to depend more and more on annual gifts to balance college budgets.

A major premise underlying the analysis which follows is that improvement of private higher education's rather precarious financial position, and its maintenance as a strong independent force, will require effective development of more comprehensive, less obtrusive, sources of indirect support that can be used in combination to promote stability. A related assumption is that true independence can be maintained only in the absence of government regulation.

The simple thesis of the paper is that the federal tax system (and, by implication, those of the states) is a rich and variegated source of increased indirect revenue, with the additional benefit of only minimal attendant governmental control; and moreover, that private higher education still has not fully recognized its potential advantages over other sources of support.

The discussion begins with a careful review of the common law heritage of preferential tax treatment, emphasizing recent issues, cases, and activities involving exempt organizations. Next, the historical purposes, impact, and rules governing the charitable deduction are reviewed, followed by a

summary of the findings and recommendations of the Filer Commission and a brief discussion of some current political forces that run counter to its central assumptions. Finally, four areas of potential administrative involvement in tax matters are discussed: implementing donor directions, offering tax advice about contributions, effectively defending "philanthropic logic" in the face of "tax logic," and providing representation and personal tax services for faculty, staff, and students.

The discussion is undertaken with the view that, in recent years, the general tax climate has not been favorable toward higher education. The withdrawal of the home office deduction for faculty, the near *de facto* repeal of exclusion from taxation of scholarships, the recent assault on tuition remission, and the withdrawal of inducements for corporations to establish educational trusts for employee tuition plans are cited as evidence. According to the author, these trends indicate a basic weakness in representing higher education interests before Congress and the IRS. Just one indication of this was the recent removal of tax advantages supporting corporate educational trusts while Congress was simultaneously enacting a law, *identical in effect*, that would stimulate employer contributions to prepaid legal service plans.

This volume is the result of a fall 1976 conference sponsored jointly by The Center for the Study of Higher Education and the College of Law of The University of Toledo entitled, "The Law in Higher Education: A Workshop for Administrators." A companion volume, focusing on tort liability, faculty contracts, lawsuit components, academic discipline, record-keeping, student due process, and compliance with federal regulations, contains the remaining papers presented at the conference.

The author, Professor Gerald P. Moran, possesses considerable expertise in the matter under discussion. He is familiar with both the latest provisions of the Code and the approaches various interest groups, other than education, take

to change the system. Among his other qualifications, Professor Moran served as a staff tax attorney for the IRS Exempt Organizations Branch in Washington, D.C., where he was directly concerned with provisions and interpretations of the Code relating to eleemosynary organizations. Thus, his insights and suggestions are offered with the authority of one who has been directly involved in the inside operations of the agency he discusses, the problems he seeks to remedy, and the solutions he seeks to implement.

We are pleased to be able to make this competent and frank discussion of private higher education's current tax status available as a regular Center monograph. We believe that it will be of interest and assistance to a wide variety of spokesmen and participants actively seeking to insure the long-term viability of independent colleges and universities.

February 1977

*Vance T. Peterson, Ph.D.
Associate Director,
The Center for the Study of
Higher Education*

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INTRODUCTION*

I am very pleased to be a part of this intensive focus on Law in Higher Education because it provides a unique opportunity to review many of my own personal experiences. During the early sixties, I spent an extensive amount of time engaged in study and research while working for the Internal Revenue Service (hereinafter IRS). As part of my duties in the Exempt Organizations Branch of the IRS, I was involved in a special project¹ aimed at developing audit guidelines to distinguish "educational" materials from "propaganda" and to provide clarification as to what activities are in the nature of "attempting to influence legislation." Also examined as part of this project was the question of what activities constitute "intervention in . . . any political campaigns."

These questions were not considered in the abstract, but in connection with the possible revocation of a specific organization's tax-exempt status. For example, some of the issues raised were:

- a. Whether an organization which distributed John Birch Blue Books to public schools and libraries was engaged in charitable or educational activities as those terms are defined by § 501 (c) (3) of the Internal Revenue Code?²
- b. Whether the activities of the Daughters of the American Revolution, by adopting ten or more political resolutions at its annual convention, were substantial attempts to influence legislation as proscribed by § 501 (c) (3)?

* The author wishes to express his appreciation for the special research contribution of Charles F. Myers (J.D. expected 1977) and the valuable research assistance of Cynthia J. Pinciotti (J.D. expected 1977). The author also wishes to acknowledge the efficient and generous service of his secretary, Helen E. Hatcher.

1. This project was loosely referred to as the Ideological Study by the IRS.
2. Future section references in the text will be to the Internal Revenue Code of 1954 unless otherwise indicated.

- c. Whether certain religious organizations which strongly advocated particular positions on proposed legislation were engaged in proscribed substantial attempts to influence legislation or were excepted from such restriction as long as their positions were based upon religious tenets?

During the Kennedy and Johnson Administrations, these studies by the IRS focused on allegedly "conservative" tax-exempt organizations, although a few "liberal" organizations were also examined. Similar to many other projects of the federal government, its purposes were unrealistic, and its objectives were clearly weighted by the existing values of the contemporary administration.³ This is possible as long as there exists, as perhaps there must, broad administrative discretion in the interpretation of such vague terms as "charitable" and "educational." Thus, each incoming administration is relatively free, except in the most abusive situations, to render decisions reflecting its political policies and values.⁴

After an exhaustive study, the IRS recognized the impossibility of adequately resolving these complex questions

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3. The existence of this special study has been extensively examined by the Joint Committee on Internal Revenue Taxation. See Investigation of the Special Service Staff of the Internal Revenue Service, prepared for the Joint Committee on Internal Revenue Taxation, 94th Cong., 1st Sess. 101-14 (1975).
4. The Nixon administration represented one of the most serious attacks on the fair administration of the tax laws. See *Center on Corporate Responsibility, Inc. v. Shultz*, 368 F. Supp. 863 (D.C.D.C. 1973), and *Tax Reform Research Group v. Internal Revenue Service*, ___ F. Supp. ___, 34 AFTR 2d par. 76-5178 (D.C.D.C. 1976) for a discussion of the extent to which the Nixon administration attempted to interfere with the Internal Revenue system. See also the dissenting opinion of Justice Blackmun in *Commissioner v. Americans United, Inc.*, 416 U.S. 752, 774 (1973), wherein he stated:

The program of exemption by letter ruling, therefore, is tantamount to a licensing procedure. If the Commissioner's authority were limited by a clear statutory definition of § 501(c) (3)'s requirement of "no substantial part," or by an objective definition of what is "charitable," there would be less concern about possible administrative abuse. But

and accepted what you already know — that it is difficult, if not impossible, to know what is educational as opposed to what is propaganda or where religion ends and attempts to influence legislation begin. The best concession, although unofficial, of the IRS was that education is what you believe to be true and propaganda is what the opposition believes to be true. In any event, the important point to note here is that the IRS is more than just a collector and protector of the Treasury. Through its role in administering the laws pertaining to tax-exempt status, the IRS is actually involved in regulating the activities of those organizations which claim such a special position.

As many of you are well aware, the survival of private education, particularly colleges and universities, is now confronted with its most difficult economic challenge. Agitated in recent years by unprecedented double-digit inflation, some private colleges which have neither adequately prepared for the dramatic cost increases nor achieved successful fund-raising programs have had to pay the ultimate penalty — termination.⁵

The interplay between the federal tax system and private colleges will intensify as the demands increase for additional

where the philanthropic organization is concerned, there appears to be little to circumscribe the *almost unfettered power of the Commissioner*. (emphasis added) (footnotes omitted)

To alleviate this problem, Congress responded in the Tax Reform Act of 1976 by adopting a procedure to accelerate litigation of the exemption issues. Section 1306 of the Tax Reform Act of 1976, enacting I.R.C. § 7428.

5. Since 1969, over 150 private colleges have closed. REPORT OF THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR 80 (1975) [hereinafter cited as FILER COMMISSION REPORT]. This report should be required reading for all private college administrators.

It should be added that there is no intention here to provide a definitive statement as to the economic and educational vitality of private higher education. That question and its study are left to other authorities. Undoubtedly, there is here, as in other fields, a tendency to

financial support from traditional sources and new sources of revenue are sought. In recent years, there has been increasing demand by private colleges for direct public support without the concomitant "evil" of government regulation.⁶ The federal tax system provides a vital, yet not fully recognized, resource to private colleges since, through its modification, increased revenues may be generated without additional regulatory controls being placed upon the beneficiary educational institutions.

At the same time, publicly supported institutions of higher learning are accelerating their efforts to locate private financial support, realizing that state legislatures can no longer be expected to be the principal source of support for future growth.⁷ This situation will result in intense competition between private and public educational institutions for limited financial resources. Moreover, the competitors will be forced

make overstatements in response to specific crises. A recent comprehensive report reveals both a state of surprising steadiness in private higher education without stagnancy, notwithstanding the existence of obvious and important signs of economic and educational distress. H. BOWEN & W. MINTER, *PRIVATE HIGHER EDUCATION, SECOND ANNUAL REPORT ON FINANCIAL AND EDUCATIONAL TRENDS IN PRIVATE SECTOR OF AMERICAN HIGHER EDUCATION 99-100* (Association of American Colleges 1976). See also Fiske, "Private Colleges in Peril," *The New York Times*, Feb. 29, 1976, at 1, col. 1.

6. Kingman Brewster, President of Yale University, outlined the many dangers attendant to federal aid to higher education through the regulatory strings attached to such aid in a speech delivered at the centennial celebration of the University of Oregon. See Scully, "Brewster on Government Strings," *The Chronicle of Higher Education*, Jan. 26, 1976, at 3, col. 2.
7. Glen Driscoll, the President of the University of Toledo, recently addressed the dilemma of higher education in Ohio:

The State of Ohio is at a major crossroad for higher education. It must decide within the next six months what priority rank higher education will hold. Indeed it must decide whether or not public education is going to be "public." You see, the word "public" means that most of the financial support is supplied by the general public, not

to cross traditional boundaries; that is, private institutions of higher learning will seek, directly or indirectly, public funds and public institutions will actively solicit private sources of revenue. This competition may be as interesting as Sunday T.V. football, and may possibly be as violent.⁸

Apart from the competition for funding, the straitened circumstances of private colleges raise one of the major national issues in education - whether private education will find sufficient resources to survive. If so, the next major concern is whether the essential ingredients of private

by the individual student. It also means that a higher education opportunity is available to all who have the talent, desire, and ambition to take advantage of it. Those conditions may be about to change in Ohio. Students are going to be asked to pay a larger share. And as that share increases, more and more of them will discover that they cannot afford the price; thus the opportunity is no longer available. At that point higher education becomes less public, and more private. That is, the cost is carried by the private individual consumer rather than by the public taxpayer. We seem to be moving back toward the 19th century.

Speech of Glen R. Driscoll, President of the University of Toledo, delivered during commencement exercises at the University of Toledo, Dec. 10, 1976.

8. The kick-off has already taken place. See the statement of Allan W. Ostar, "The state's first commitment must be to its public institutions, and it's time to emphasize this to state officials." *Cf.* statement of Terry Sanford, President, Duke University, "That the principal proponents of starving the private colleges off the land should be many of you who lead public colleges, I find appalling. Where is your educational leadership?" Scully, "Public, Private Colleges in Open Conflict over Support," *The Chronicle of Higher Education*, Nov. 22, 1976, at 1, col. 2.

The recent proposal of a special state commission to study financing of higher education recommends a reduction in direct aid to educational institutions with a corresponding substantial increase in tuition assistance to students for the purpose of improving the competitive position of private institutions of higher learning. The report was immediately criticized by Dr. Edward J. Bloustein, President of Rutgers University, who remarked that, if adopted, it would result in "the end of public higher education as we know it in New Jersey." Fiske, "Jersey Study Urges Less Direct Aid to Colleges, but More to Students," *The New York Times*, Jan. 13, 1977, at 1, col. 2.

education will have to be sacrificed for the sake of survival.⁹ The answers to these questions will ultimately depend upon the ability and political effectiveness of college administrators to articulate a rational basis for the importance of private education as a priority item on the agenda of our modern society.

Of tantamount importance is that you, as college administrators, should be aware of how the current federal tax system applies to specific operations of private colleges. For example, to what extent are certain income-producing activities of the educational institution subject to the imposition of a federal income tax? Consider the disastrous results if you set sail to new fiscal islands of revenue by initiating that pet project without adequate tax planning. Absent legal and tax navigation, your ship may be doomed to crash upon the statutory shores of the Internal Revenue Code with attendant loss of cargo, increased costs, and perhaps even the imposition of personal liability.

Life is not always so grave. But the skills of a lawyer, like those of a preacher, lie in maintaining your interest by pointing out the technical dangers which may result in your "legal damnation." Accordingly, the principal objective of this article is to provide the college administrator with an overview of the current federal tax system as it relates to the operation and growth of private colleges. It should be noted here that the discussion of the impact of the federal tax system applies equally as well to public institutions of higher learning. It is hoped that this overview will provide you with sufficient insight to identify the problem areas and thus seek legal assistance before a questionable project is undertaken.

9. In analogous sense, it reminds one of the classic remark by a general during the Vietnam War when he said, "We had to destroy the town to save it."

I.

THE EXEMPTION FROM FEDERAL INCOME TAXATION

Before reviewing the statutory developments regarding the federal income tax exemption of private colleges and other eleemosynary institutions, it is helpful to briefly note the historical common law roots that underlie the granting of preferential tax status to specific organizations.

Justice Holmes once astutely remarked that "[a] page of history is worth a volume of logic."¹⁰ This often-quoted observation by the noted jurist is particularly germane when examining the present preferential status accorded by the federal tax system. These preferences are based on the practices of past institutions; a study of the history and values of earlier societies reveals, in part, the foundation for conferring the current special status. While the particular philosophical ideology offered in support of legal preferences may change, the continued existence of such status becomes an unconsciously accepted heritage, like a communal bequest, which is silently carried forward to our contemporary society.

There exists a substantial distortion factor in briefly condensing a few hundred years into a paragraph or less. It is comparable to plucking two apples from an assorted fruit basket and then concluding that it is a basket of apples.¹¹ Notwithstanding this serious reservation, there are discernible cultural values which were brought to the American shores. Human experience does not begin in 1492, or in 1776, but may be crystallized into crucial events which are historical bridges, signifying both an end to one era and the beginning of the next.

10. This statement of Justice Holmes appeared in *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921).

11. See 1 POLLOCK & MAITLAND, *HISTORY OF ENGLISH LAW* I (2d ed. 1898) [hereinafter cited as 1 POLLOCK & MAITLAND].

In this sense each new community contains within it parts of the prior culture whether consciously or not; nothing is completely original.

A. Common Law Heritage

As primitive man emerged into socialized patterns of tribal existence, a few members of each group claimed, in general, both a special knowledge and an ability to understand the supernatural forces. These particular claims were accepted to varying degrees and such persons, whether known as medicine men or priests, were accorded special preferences within those primitive societies.¹² Most of our recognized professions (religion, medicine, education) can trace their beginnings to the institutions which evolved from the early magician-prophet-priest figure.

In this perspective, it is reasonable to observe that the initial principal evolution from the witchdoctor figure would be in religion, in view of the limited scientific knowledge during the Middle Ages and the effective political skills of representatives of religion. This proposition can be demonstrated by the gradual expansion of the Christian church within the Roman Empire where it became, during Constantine's reign, the principal medium for distributing public funds for the benefit of the underprivileged as well as the state-recommended recipient of charitable contributions.¹³ Despite the withdrawal of the Roman Legions from England (407 A.D.) less than one

12. See M. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 11-54 (1965) [hereinafter cited as FREMONT-SMITH]; M. LARSON & C. LOWELL, THE RELIGIOUS EMPIRE 8-18 (1976) [hereinafter cited as LARSON].

13. FREMONT-SMITH, *supra* note 12, at 14. See Duff, *The Charitable Foundations of Byzantine*, in CAMBRIDGE LEGAL ESSAYS 83-84 (1926). While religious liberty as a reality was left many centuries later, Constantine's Edict of Tolerance (313 A.D.) remains, even under current standards, a classic statement of statutorily protected religious freedom. The Edict stated in part:

that you might understand that the indulgence which we have granted in matters of religion to the Christians is

hundred years after Constantine's grant of religious liberty to Christians and others, one of the institutions to survive the Roman departure was Christianity.¹⁴ The subsequent resurgence of Christianity in England was due to the influence of monks educated in highly learned Irish monasteries as well as missionaries from the Roman church.¹⁵ In fact, the two separate sources of Christian expansion competed for control of religious matters. The conflict was resolved in favor of the authority of the Bishop of Rome at the Synod of Whitby in 664 A.D.¹⁶

Through the political astuteness of several popes as well as the invocation of important religious symbols, the church enhanced its status in England and on the European continent. The eventual internationally recognized and protected position of the church was, in fact, achieved by the skillful employment of knowledgeable and dedicated representatives.¹⁷ The Norman Conquest in 1066 further secured the position of the Roman church in England.¹⁸

ample and unconditional; and perceive at the same time that the open and free exercise of their respective religions is granted to all others, as well as to Christians. For it befits the well ordered state and the tranquility of our times that each individual be allowed, according to his own choice, to worship the Divinity; and we mean not to derogate aught from the honour due to any religion or its votaries . . .

I THE SHAPING OF WESTERN CIVILIZATION 184-85 (Schaefer, Resnick, & Netterville eds. 1970).

14. W. HALL, R. ALBION & J. POPE, A HISTORY OF ENGLAND AND THE EMPIRE-COMMONWEALTH 12 (4th ed. 1961) [hereinafter cited as HALL]. See I POLLOCK & MAITLAND, *supra* note 11, at 3-4.

15. HALL, *supra* note 14, at 12-13.

16. *Id.* at 13.

17. The representatives included, among others, priests, monks, missionaries, nuns, financiers, legalists, philosophers, and royalty.

18. FREMONT-SMITH, *supra* note 12, at 17. For a number of reasons, William the Conqueror pursued his English adventure with the blessing

Since the church was also a multi-faceted institution composed of diverse groups with specialized talents, it alone had the administrative facilities for delivering aid to the poor, as well as providing educational and medical service for the benefit of the entire community. The church would explain its moral obligation to provide these services on the basis of its religious tenets. Hence, many of the services originally (and still considered) charitable were conducted through the exclusive medium of the church. It was not until much later, as the middle-class emerged politically from their feudal roles, that secular private institutions provided the same services previously only delivered by the church. Between the 12th and 15th centuries, the seeds of secular and non-monastic involvement in education can be observed in the development of the two early English institutions of higher learning, Oxford and Cambridge.¹⁹ Nevertheless, monasteries retained virtual control of education until the 16th century.²⁰ Similar to the educational developments, many new secular private groups were formed for the purpose of maintaining hospitals and providing other charitable services.²¹

The church, while enjoying many special privileges²²

of the Pope. There was, however, later conflict as to the jurisdictional powers between the King and Pope. See HALL, *supra* note 14, at 40, 51-52.

19. See FREMONT-SMITH, *supra* note 12, at 21. See also E. FISCH, D. FREED & E. SCHACHTER, CHARITIES AND CHARITABLE FOUNDATIONS 260 (1974) [hereinafter cited as FISCH]; HALL, *supra* note 14, at 94-96.

20. Between 1536 and 1540, all monasteries in England were dissolved as part of the break of relations with the Roman church. The monastic monopoly of education did not terminate until their abolition during this period. HALL, *supra* note 14, 185-86.

21. FREMONT-SMITH, *supra* note 12, at 21-23. See also FISCH, *supra* note 19, at 273-275.

22. The special privileges were, of course, in forms pertinent to the existing institutions. In essence, the preferential claims of the church reflected the ideological struggle for supremacy over civil authority. The

during the medieval period, eventually became a political and economic threat to the English kings. Through increasing contributions of real and personal property, the church held significant wealth in England by the time of Henry VIII's reign.²³ To counter the church's economic strength and political power, governmental institutions attempted to reduce or abate its special position. When the long expected termination of relations between England and the Roman church occurred, many of England's impoverished constituents were left without charitable services until the new secular and successive religious institutions, as well as the government, could replace these important social services.²⁴

While certain administrative abuses of the church stimulated the regulatory efforts of the English monarchy,²⁵

privileges included exemptions from certain feudal obligations such as scutage, the right to separate ecclesiastical courts under law, the right to benefit of clergy (which concept led in part to Thomas Becket's untimely death) which involved the priority of the church's courts jurisdiction over wrongs done by clergy, as well as the right to financial support for repair of churches, tithes and other forms of emoluments; and finally most of the laypersons were subject to canon laws regarding marriages, divorces, testaments and intestate succession. See I POLLOCK & MAITLAND, *supra* note 11, at 34, 35, 124, 125, 127, 433-57, 498, 612-14. It is interesting to note that Pope Boniface VIII (1294-1303) took the position in his bull *Clericis Laicos* that no civil institution could demand money from the clergy without permission from Rome. This position was partially in response to King Edward I's attempt to impose a heavy income tax in 1294 on the clergy. See HALL, *supra* note 14, at 113-15. There were also direct lines of support to Rome through the "annates" or "first fruits" obligations of abbots and bishops to pay their first year's income to Rome and "Peter's pence," an annual contribution of one penny for every hearth in England, which also went to Rome. *Id.* at 180-81. See *id.* at 77, 88.

23. FREMONT-SMITH, *supra* note 12, at 21-23. See LARSON, *supra* note 12, at 14.

24. HALL, *supra* note 14, at 186.

25. Shortly before the abolition of the monasteries, it was clear that certain charitable dedications were not carried out according to the donor's directions and that some charitable endowment funds were lost. FREMONT-SMITH, *supra* note 12, at 22-23.

the principal motivation was for political control over wealth and its related social aspects vis-a-vis the powers of the papacy. This political struggle was never completely resolved and religion in general, as opposed to the early unified Christian church, survived with retained, albeit somewhat modified, specialized preferences.

With the increased secular delivery of charitable services and the reported abuses of the now dissolved monasteries, Parliament reacted by adopting the Statute of Charitable Uses²⁶ during the final years of Queen Elizabeth I's reign. There were several objectives of the statute, including to indirectly define charity by listing those activities which were accepted as charitable; to provide for a method to investigate alleged charitable abuses; and finally, to provide a legal basis for enforcing the dedications of a charitable trust.²⁷ This statute

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26. The Statute on Charitable Uses provided, *inter alia*, that charitable purposes included giving property for purposes such as:

some for relief of aged, impotent and poor people, some for maintenance of sick and maimed soldiers and mariners, schools of learning, free schools, and scholars in universities, some for repair of bridges, ports, havens, causeways, churches, seabarks and highways, some for education and preferment of orphans, some for or towards relief, stock or maintenance for houses of correction, some for marriages of poor maids, some for supportation, aid and help of young tradesmen, handicraftsmen and persons decayed, and others for relief or redemption of prisoners or captives, and for aid or ease of any poor inhabitants concerning payments of fifteens, setting out of soldiers and other taxes.

STAT. 43 ELIZ. I, c. 4 (1601).

27. FREMONT-SMITH, *supra* note 12, at 23-24; 4 A. SCOTT, THE LAW OF TRUSTS § 368, at 2853-58 (3d ed. 1967).

The Statute of Charitable Uses was held to be part of our common law by the United States Supreme Court. *Vidal v. Girard's Executors*, 2 How. 127, 11 L. Ed. 205 (U.S. 1844). In spite of this position, several states felt that it was necessary for their legislatures to enact such a statute. See 4 A. SCOTT, THE LAW OF TRUSTS § 348.3, at 2788 (3d ed. 1967). See also Adams, *Racial and Religious Discrimination in Charitable Trusts: A Current Analysis of Constitutional and Trust Law Solution*, 25 CLEV. ST. L. REV. 1-23 (1976.)

marks the first major effort at governmental regulation of charitable organizations which continues, in the United States, through the principal medium of the federal tax system.²⁸

The early colonists carried this charitable-legal tradition to America, even though many had left Europe precisely because of severe religious oppression. The United States Supreme Court recently noted the importance of this common law tradition in *Walz v. Tax Commission of the City of New York*.²⁹ In *Walz*, the Supreme Court held that the state tax exemption for property owned by religious organizations did not violate the "establishment" clause of the First Amendment.³⁰ In so holding, the Court reasoned that:

All of the fifty states provide for tax exemption of places of worship, most of them doing so by constitutional guarantees. For so long as federal income taxes have had any potential impact on churches — over 75 years — religious organizations have been expressly exempt from the tax. Such treatment is an "aid" to churches no more and no less in principle than the real estate tax exemption granted by the states. Few concepts are more deeply embedded in the fabric of our national life, beginning with pre-Revolutionary colonial times, than for the government to exercise at the very least this kind of benevolent neutrality toward churches and religious exercise generally so long as none was favored over others and none suffered interference.³¹

28. Compare the list of activities considered to be charitable under the Statute of Charitable Uses at note 26 *supra*, with the regulations under I.R.C. § 501 (c) (3) at note 74 *infra*. For a further discussion of the English legal developments from 1600 to 1960 regarding the regulation of charities, see FREMONT-SMITH, *supra* note 12, at 27-36.

29. 397 U.S. 664 (1970).

30. See note 33 *infra*.

Thus, this deeply rooted common law tradition concerning religion and charity is deeply embedded in our state and federal tax statutes which provide for the exemption of specified organizations. The types of direct services previously provided exclusively by the church, such as medical, educational and relief for the poor, and codified by the Statute of Charitable Uses, were generally accepted as being charitable. When religious associations or independent secular organizations provided the same charitable services in America, they could rightfully claim a special legal preference, including tax-exemption, on the same ideological basis as the church during the medieval period. Until recently, the claims of religious and charitable organizations were generally accepted without extensive conflict or consideration. At the present time, religious organizations, *per se*, continue to qualify for the tax-exempt status, notwithstanding the failure to provide social services in specific cases,³² and despite the deep concern of the founding fathers for the separation of church and state.³³

B. Statutory History of § 501 (c) (3)³⁴

The first income tax law passed by the United States

31. 397 U.S. at 676-77.

32. In *Walz*, the Court also specifically refused "to justify the tax exemption on the social welfare services or 'good works' that some churches perform for parishioners and others — family counselling, aid to the elderly and the infirm, and to the children." 397 U.S. at 674.

The intimate relationship between education and religion can be observed in the founding of the early institutions of higher learning during the American colonial period. See F. RUDOLPH, *THE AMERICAN COLLEGE AND UNIVERSITY: A HISTORY* 1-22 (1962).

33. "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech or of the press; or the right of the people peaceably to assemble, and to petition the government for a redress of grievances." U.S. CONST. amend. 1.

34. I.R.C. § 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

Congress was in 1861 to partially finance the cost of the Civil War.³⁵ It was not until 1864 that an amendment exempted from tax "managers . . . of any charitable, benevolent, or religious association" if they filed and proved to the satisfaction of the local collector of taxation that the profits would be applied to the "relief of sick and wounded soldiers, or to some other charitable use."³⁶

The income tax act of 1894, similar to the Civil War income tax, specifically provided for exemption from income taxation of "corporations, companies or associations organized and conducted solely for charitable, religious or educational purposes"³⁷ This exemption provision did not become effective, however, since the 1894 income tax amendment was held to be unconstitutional.³⁸

(c) LIST OF EXEMPT ORGANIZATIONS.

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

35. Act of Aug. 5, 1861, ch. 45, §§ 1-58, 12 Stat. 292-313. It may be of some surprise that the first income tax levied in America was imposed by the Colony of Massachusetts in 1634, only fourteen years after the landing at Plymouth. See H. WHITE, *THE FEDERAL INCOME TAX LAW* 4, n.2 (1913).

36. Act of June 30, 1864, ch. 173, § 111, 13 Stat. 279.

37. Act of Aug. 27, 1894, ch. 349, § 32, 28 Stat. 556.

38. *Pollock v. Farmer's Loan & Trust Co.*, 157 U.S. 429 (1894), which was reconsidered and affirmed, 158 U.S. 601 (1895). The fact that the similar Civil War income tax law was held constitutional is often forgotten. *Springer v. United States*, 102 U.S. 586 (1880).

Nonetheless, a similar provision was included in the Corporation Excise Tax Act of 1909.³⁹ That Act imposed an income tax on corporations for the privilege of doing business.⁴⁰ Section 38 of the Act explicitly exempted "corporations or associations organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inured to the benefit of any private stockholder or individual."⁴¹ After the ratification of the Sixteenth Amendment,⁴² a similar statutory exemption was included in the Income Tax Act of 1913.⁴³

According to official congressional records, there does not appear to be a clearly defined basis for the exemption of certain charitable organizations from taxation. One popular theory is that where private non-profit charitable organizations provide essentially governmental services, it would be unfair to tax such organizations.⁴⁴ It is also likely that the exemption may be founded, at least in part, on the belief that

39. Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 113.

40. 36 Stat. 112.

41. *Id.* at 113.

42. "The Congress shall have power to lay and collect taxes or incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." U.S. CONST. amend. 16.

43. The 1913 Act, however, added the term "scientific." Act of Oct. 3, 1913, ch. 16, § 11 G(a), 38 Stat. 172. The term "literary" and the phrase "or for the prevention of cruelty to children or animals" was added in 1921. Revenue Act of 1921, ch. 136, § 231, 42 Stat. 253.

44. Thomas B. Curtis, a former member of the House Ways and Means Committee, expressed this theory in the following manner:

To remove exemptions written into the federal income tax law at its inception seems, at first blush, to be a movement toward tax neutrality. However, it takes on a different hue when one considers some of the arguments for it. A tax exemption is alleged to be a way of getting around the authorization-appropriation process of the Congress-the

there is little income tax to be derived from such organizations. In any event, there can be little doubt that the principal reason for granting the exemption from taxation to charitable organizations was based essentially on our common law heritage rather than on any newly developed ideology. In fact, through the years Congress has seldom focused on or searched for a rational ideology whereby charitable organizations have justified their preferential tax treatment;⁴⁵ rather it has made a series of pragmatic legislative responses to deal with specific abuses which the courts determined to be allowable under existing tax statutes. As political activities and sophisticated tax avoidance techniques exploited the tax-exempt status of certain organizations, Congress gradually responded with the imposition of restrictions and additional taxes to combat the alleged abuses.

C. Definitional Conflicts and Legislative Responses

Many of the statutory restrictions on exempt organizations represent the congressional response to the judicial and administrative difficulties encountered in defining the terms of § 501 (c) (3). In *Slee v. Commissioner*,⁴⁶ Judge Learned Hand

way to avoid taking up directly an expenditure program. This argument would be meritorious if a tax exemption were granted for an endeavor for which Congress had not made an expenditure policy decision. However, once the governmental policy has been made to see that more hospitals are built, the choice becomes one of whether hospitals are built more efficiently and to best meet the needs in kind and by geography through governmental or through private and local action. Certainly it seems appropriate for tax writers to take this governmental expenditure decision into account and to say we will not seek to get taxes to support this program from moneys being spent privately for this same purpose.

Curtis, *It Depends Upon How You Look At It*, in TAX IMPACTS ON PHILANTHROPY 217-18 (1972).

45. Bittker & Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 301-04 (1976).

46. 42 F. 2d 184 (2d Cir. 1930).

stated that the American Birth Control League could not be considered as exclusively operated for charitable and educational purposes in view of its active opposition to laws preventing the dissemination of birth control information. In reaching this decision, Judge Hand explained that:

Political agitation as such is outside the statute, however innocent the aim, though it adds nothing to dub it "propaganda," a polemical word used to decry the publicity of the other side. Controversies of that sort must be conducted without public subvention; the Treasury stands aside from them.⁴⁷

After further litigation on the distinction between educational and political activity,⁴⁸ Congress amended the exemption provision in 1934 by adding the restriction that "no substantial part of the activities of which is carrying on propaganda or otherwise attempting to influence legislation."⁴⁹ Because the IRS was arguing for a very restrictive definition of education, Norman A. Sugarman, a former Assistant Commissioner, suggested that the intent of such legislation was to provide more liberal guidance in administering the statute which provided for exemption to educational organizations.⁵⁰

47. *Id.* at 185. In so holding, Judge Hand also stated that it was allowable for a state university to constantly request appropriations from the state legislature without violating its exclusively educational purposes.

48. *Leubruscher v. Commissioner*, 54 F. 2d 998 (2d Cir. 1932); *Weyl v. Commissioner*, 48 F.2d 811 (2d Cir. 1931); *James J. Forstall*, 29 B.T.A. 428 (1933).

49. Revenue Act of 1934, ch. 277, § 101, 48 Stat. 700. See S. Rep. No. 558, 73d Cong., 2d Sess. 26, 1939-1 C.B. (Part 2) 586, 606 (1934). Senators Harrison and La Follette urged an absolute rather than a "no substantial part" prohibition. 78 Cong. Rec. 5959 (1934).

50. Statement of Assistant Commissioner Norman A. Sugarman before the Special Committee of the House of Representatives to Investigate Foundations and Other Organizations, June 2, 1954, 83d Cong., 2d Sess. (1954), reprinted in 32 TAXES 533 (1954).

The IRS has generally been quite concerned about the restriction limiting attempts to influence legislation.⁵¹ Most of the litigation focuses on the issue of what constitutes a "substantial part" of an organization's activities. More specifically, should the term "substantial" be measured in terms of costs or activities or rather from the viewpoint of results? These administrative difficulties, as can be seen from a review of the cases, have not been resolved into a clear position.⁵²

The only other significant modification in the definition of the statutory exemption occurred in 1954 as a direct result of then Senator Lyndon B. Johnson.⁵³ With Johnson leading the way, Congress narrowed the scope of § 501 (c) (3) by providing that only those organizations which do not "participate in or

51. See *Christian and Echoes Nat. Ministry, Inc. v. United States*, 470 F. 2d 849 (10th Cir. 1972); *Seasongood v. Commissioner*, 227 F. 2d 907 (6th Cir. 1955); *League of Women Voters v. United States*, 180 F.Supp. 379, cert. denied, 364 U.S. 822 (1960). See also Clark, *The Limitation on Political Activities: A Discordant Note in the Law of Charities*, 46 VA. L. REV. 439 (1960) [hereinafter cited as Clark]; Comment, *The Sierra Club, Political Activity and Tax-Exempt Charitable Status*, 55 GEO. L. J. 1128 (1967).

52. Perhaps this is one of the reasons why Congress has recently provided some limited exceptions to this restrictive legislative standard. See § 1307 of the Tax Reform Act of 1976, P.L. 94-455, amending I.R.C. § 501(h) to allow certain charitable organizations to elect to engage in limited political activities. Churches, however, are not provided with the benefits of this new provision. H. Conf. Rep. No. 94-1515, 94 U.S. Code Cong. & Adm. News 1222, at 1334 (1976).

53. In light of his complete political spirit, it's likely that the then Senator Johnson never forgot the participation of certain conservative (oil-related) tax-exempt organizations in the 1941 special senatorial election in Texas. In that election, he was leading by 5,000 votes with 96% of the vote counted but ultimately lost by 1,311. Similarly, the involvement of the same tax-exempt organizations in the 1948 senatorial election was of great concern to him, even though he won by 87 votes, and from which he was dubbed "Landslide Lyndon". See R. EVANS & R. NOVAK, *LYNDON B. JOHNSON: THE EXERCISE OF POWER* 13-14, 24 (1966); S. JOHNSON, *MY BROTHER LYNDON* 72, 75, 77 (1969); B. MOONEY, *LBJ: AN IRREVERENT CHRONICLE* 53 (1976).

intervene in (including the publishing or distribution of statements), any political campaign on behalf of any candidate for public office" will qualify for the special status.⁵⁴ This prohibition is stated in absolute terms; thus any intervention, however insignificant, will preclude qualification for exemption under § 501 (c) (3).

Despite the apparent absolute prohibition against campaign intervention, the IRS, unlike its position regarding proscribed attempts to influence legislation, has failed to enforce the strict statutory standard. For example, each presidential campaign reveals a number of instances of intervention in varying degrees by tax-exempt organizations, but there is little or no enforcement of the restriction.⁵⁵ The author believes that the revocation of an organization's tax-exempt status on the basis of a few isolated acts of intervention would be so harsh as to be inherently unreasonable. Consequently, the IRS will probably continue in its unstated administrative position of not enforcing this restriction.

1. Recent Definitional Difficulties

In recent years, the definition and application of the terms "charitable" and "educational," as used in § 501 (c) (3), have been questioned in light of changing social values and modern business practices. During the late sixties, the IRS took the position that private, segregated primary and secondary schools qualified both for exemption as a § 501 (c) (3) organization and as a charitable donee under § 170 (c) as long as they do "not have such degree of involvement with a political

54. I.R.C. § 501(c) (3).

55. See Clark, *supra* note 47, at 459. A typical example of an issue regarding this restriction is whether the U.S. Catholic Bishops' meetings with the presidential candidates and the attendant press releases represent the type of conduct that sufficiently constitutes the proscribed intervention in a political campaign.

subdivision as has been held by the courts to constitute State action for constitutional questions . . ."⁵⁶

In 1969, a class action was filed requesting the court to enjoin the Commissioner of the IRS from issuing any rulings that private segregated schools do not qualify under either § 170 (c) or § 501 (c) (3). In *Coit v. Green*,⁵⁷ the Supreme Court affirmed the district court's decision that it was unnecessary to find state action where the federal government was providing significant and substantial support to the segregated schools through the application of the Internal Revenue Code.⁵⁸ These factors were sufficient to constitute a governmental involvement in violation of the due process clause of the Fifth Amendment.⁵⁹ Thus, the position of the IRS, which had required state action, was undercut by the finding of sufficient federal involvement through the tax code.

56. IRS Press Release, 1967 CCH Standard Federal Tax Reporter par. 6734 (August 2, 1967).

57. *Green v. Kennedy*, 309 F. Supp. 1127 (D.C.D.C. 1970), *sub nom.* *Green v. Connally*, 330 F. Supp. 1150 (D.C.D.C. 1971), *aff'd per curiam sub. nom.* *Coit v. Green*, 404 U.S. 997 (1971).

58. *Green v. Connally*, 330 F. Supp. at 1156.

59. See *Green v. Kennedy*, 309 F. Supp. at 1134-37. It is interesting to note that the segregated school system of the Federal Government was found unconstitutional as violative of the due process clause of the Fifth Amendment. *Bolling v. Sharpe*, 347 U.S. 497 (1954). A public segregated school system operated by the state has been found to be in violation of the due process clause of the Fourteenth Amendment. *Brown v. Board of Topeka*, 347 U.S. 483 (1954). The application of the Fourteenth Amendment is dependent upon a finding of state action which was the sole legal theory offered by the IRS to disallow qualification for exemption. See generally Nelkin, *Cy Pres and the Fourteenth Amendment: A Discriminatory Look at Very Private Schools and Not So Charitable Trusts*, 56 GEO. L. J. 272 (1967). Not all private schools have desired to circumvent to prohibition against racial discrimination. See *Rice University v. Carr*, 9 RACE REL. L. REV. 613 (Harris County Ct. 1964), *aff'd sub. nom.* *Coffee v. William Marsh Rice Univ.*, 408 S.W.2d 269 (Tex. Cir. App. 1966), where Rice University and its trustees proceeded in state court to eliminate the restriction allowing admission to only "white students."

After the change in the position of the IRS as to the qualification of private segregated schools under § 501 (c) (3) at the primary and secondary levels,⁶⁰ the IRS then attempted to revoke the tax-exempt status of a private university which, based on the belief that God intended the races to be separate, refused to admit non-whites.⁶¹ This issue is more complex since it also involves the right to practice religion which is protected by the First Amendment.⁶² Moreover, in *Runyon v. McCrary*,⁶³ the Supreme Court last year upheld a black student's right to sue a private school which denied him admission and which, although it was not tax-exempt, did not admit non-whites.⁶⁴ Thus, in some instances, there may be a legal clash of apparently equal values: the free exercise of religion balanced against the restriction against racial

60. Technically, the Commissioner reversed his position before the termination of the litigation in *Coit v. Green*. IRS News Release, 1970 CCH Standard Federal Tax Reporter par. 6790. Allegedly Commissioner Randolph Thrower incurred the disfavor of the Nixon Administration for his reversal of position. See *Wall Street Journal*, Jan. 14, 1970, at 2, col. 2.

61. See *Bob Jones University v. Simon*, 416 U.S. 725 (1974), where the University attempted to enjoin its revocation by the IRS pending litigation on the merits of its qualification for exemption. Since the loss of tax-exempt status also results in disqualifying the organization as a charitable donee under I.R.C. § 170(c), most organizations contend, with good reason, that they will not be able to operate even if they win since they may lose thousands of dollars in contributions during the interim litigation period. The Tax Reform Act of 1976 enacted one favorable procedural provision which allows an organization the right of direct appeal to the United States Tax Court upon the receipt of an adverse ruling on its qualification for exemption. I.R.C. § 7428.

62. The right of parents to meet state educational requirements by sending their children to private schools has long been recognized. See *Pierce v. Society of Sisters*, 268 U.S. 510 (1925).

63. 96 S.Ct. 2586 (1976). For a brief history of the development of private white schools to circumvent *Brown v. Board of Education* and the Civil Rights Acts, see Comment, *Private Discriminations under the 1866 Civil Rights Act: In Search of Principled Constitutional and Policy Limits*, 7 U.TOL. L. REV. 139, 140-149 (1975).

64. 96 S.Ct. at 2594.

discrimination. It would seem that a reasonable limitation on the practice of religion could include a prohibition against racial discrimination,⁶⁵ notwithstanding the high standard of the religious protection.⁶⁶

Another important educational issue which is reappearing⁶⁷ before the United States Supreme Court is the constitutionality of a special admissions program based essentially upon race. In *Bakke v. Regents of the University of California*,⁶⁸ the California Supreme Court held that a state medical school's minority admissions program, which has the effect of denying admission to some white applicants solely because of their race, violates the equal protection rights of the white applicants.⁶⁹ The Supreme Court is currently considering whether to grant certiorari.⁷⁰ If the Court deals with the issue on its merits, there are a number of alternatives available for resolving the complex question. If, as the author believes, the Court will decide that the Constitution is color-blind as

65. The Supreme Court specifically left that issue for another day in *Runyon* when it stated the "[n]othing in this record suggests that either the Fairfax-Brewster School or Bobbe's Private School excludes applicants on basis of religious grounds, and the Free Exercise Clause of the First Amendment is thus in no way here involved." *Id.* at 2588, n.6 (emphasis added).

66. See *Mormon Church v. United States*, 136 U.S. 1 (1890).

67. The issue first appeared in *DeFunis v. Odegaard*, 507 P.2d 1169 (1973), but the Supreme Court refused to discuss the merits of the issue on the ground that plaintiff had graduated by the time the Court decided the case, 416 U.S. 312 (1974). But see Justice Douglas's dissenting opinion indicating that any "racial" admissions program was unconstitutional. 416 U.S. at 334.

68. 132 Cal. Rptr. 680, 553 P2d 1152 (1976).

69. 132 Cal. Rptr. at 683, 553 P2d. at 1155.

70. The Supreme Court did inform the university in *Bakke* that it could maintain its special admissions program for 30 days or pending disposition of the case by the Court. Roark, "Supreme Court Opens Way for Test of Preferential Admissions," *The Chronicle of Higher Education*, Nov. 22, 1976, at 1, col. 2.

Justice Douglas claimed in *DeFunis v. Odegaard*,⁷¹ then accordingly, such a special admissions program will be held unconstitutional.

Assuming the Court adopts in *Bakke* the Douglas position, this raises the interesting question of whether the IRS will be required to revoke the exemptions (as well as their status under § 170 as charitable donees) of those private colleges which have or have had unconstitutional admission programs on the analogous theory of *Coit v. Green*.⁷² Since the special admissions programs were designed in part to remedy past discrimination,⁷³ this author believes that these programs were adopted in good faith and the colleges should be allowed a reasonable time to modify their programs to comply with the new constitutional standards. During the interim period of compliance, the special tax status of the private colleges should be retained.

To what extent the private colleges are following these developments and consciously, with advice of counsel, conforming their activities to what appears to be constitutional is unclear. These issues are complex and universally applicable to all private colleges. The Supreme Court is committed to an evenhanded application of constitutional standards, yet it must address the pragmatic implications flowing from its decisions, particularly in education. These comments are aimed at raising some questions with respect to your educational institution and at creating some awareness of the

70. 416 U.S. at 334.

72. 404 U.S. 997 (1971). See notes 57-59 *supra* and accompanying text. Furthermore, would a private college, with an unconstitutional admissions program, be liable as a defendant in a suit by a white student who was denied admission, similar to the fact pattern in *Runyon v. McCrary*? See notes 63-65 *supra* and accompanying text. On the other hand, a reversal of the California Supreme Court's decision in *Bakke* would insure the legality of special admissions programs and thus would not raise the issue of either *Coit v. Green* or *Runyon v. McCrary*.

73. See *Bakke v. Regents of the University of California*, 132 Cal. Rptr. at 701, 553 P.2d at 1173 (Tobriner, J.) (dissenting opinion).

potential impact of these recent developments on its operations.

2. Charity and Modern Business Practices

The question has been raised in recent years as to whether an organization engaged in providing a traditional charitable service for a "fee" qualifies as a charitable organization under § 501 (c) (3). In essence, the operative definition of "charitable" is set forth not in § 501 (c) (3) but in the applicable Treasury regulations.⁷⁴ These interpretive regulations do not develop

74. Treas. Regs. §§ 1.501(c) (3)-1(d) (2) and (3) (1959) state: (2) *Charitable defined.* The term "charitable" is used in section 501(c) (3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c) (3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency. The fact that an organization which is organized and operated for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily prevent such organization from being exempt as an organization organized and operated exclusively for charitable purposes. The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under section 501(c) (3) so long as it is not an "action" organization of any one of the types described in paragraph (c) (3) of this section.

(3) *Educational defined* — (i) *In general.* The term "educational", as used in section 501(c) (3), relates to —

(a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(b) The instruction of the public on subjects useful to the individual and beneficial to the community.

An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or

and apply a strict definitional approach but rather list the services or activities which are considered charitable. It reminds one of the preamble of the Statute of Charitable Uses⁷⁵ which lists similar activities. The fact that an organization receives a voluntary contribution for services rendered does not, according to the regulations, prevent such organization from qualifying for exemption.⁷⁶

Under the regulations, it is clear that no real effort to deal with the issue of charging a "fee" for a service has been attempted. In connection with hospitals, the basic standard, as set forth in Rev. Rul. 56-185,⁷⁷ required hospitals to provide some medical services to the poor on a less-than-cost basis. By the late sixties the IRS recognized that most, if not all hospital services, were paid either by private insurance programs or by the federal government through Medicare or Medicaid. In

the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.

(ii) *Examples of educational organizations.* The following are examples or organizations which, if they otherwise meet the requirements of this section, are educational:

Example (1). An organization, such as a primary or secondary school, a college, or a professional or trade school, which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.

Example (2). An organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs. Such programs may be on radio or television.

Example (3). An organization which presents a course of instruction by means of correspondence or through the utilization of television or radio.

Example (4). Museums, zoos, planetariums, symphony orchestras, and other similar organizations.

75. See note 26 *supra*.

76. Tres. Reg. § 1.501(c) (3)-1(d) (2) (1959).

77. Rev. Rul. 56-185, 1956-1 C.B. 202.

Rev. Rul. 69-545,⁷⁸ the IRS first announced that a hospital still qualifies as a charitable organization despite the fact that it renders little or no free medical care to its patients. By this latter ruling, Rev. Rul. 56-185 was modified to eliminate the requirement of providing medical care for some patients without charge or at rates below cost.⁷⁹

The new position of the IRS, as expressed in Rev. Rul. 69-545, was immediately challenged by a class action. The District Court's decision,⁸⁰ finding no authority for redefining the term "charity," was promptly reversed by the District of Columbia Court of Appeals.⁸¹ The litigation terminated on a sour note when the Supreme Court held that there was no "case or controversy" and accordingly, the plaintiff class had no standing to sue.⁸² Thus, it appears that the charging of a fee for medical services will not prevent qualification for exemption, despite the absence of providing any services for free or on a less-than-cost basis. Until this decision is reversed by the Supreme Court or until Congress goes back to the drafting table,⁸³ the delivery of traditional charitable services for reasonable charges will be permitted under the statute.

All of the above issues are raised in the context of a non-

78. Rev. Rul. 69-545, 1969-2 C.B. 117.

79. *Id.* at 119.

80. *Eastern Kentucky Welfare Rights Organization v. Simon*, 370 F. Supp. 325 (D.C.D.C. 1973).

81. 506 F.2d 1278 (D.C. Cir. 1974). See Note, *Qualification of Hospitals for Tax Exempt Status as Charitable Organizations*, 7 U.TOL. L. REV. 288 (1975) (the author contends that Rev. Rul. 69-545 is an invalid attempt to alter the well established definition of the § 501(c) (3) charitable exemption).

82. 96 S.Ct. 1917 (1976).

83. As part of their report on the Tax Reform Act of 1969, the Senate Finance Committee noted the issuance of Rev. Rul. 69-545 and the House proposed amendment, but decided not to take any action on the matter. See S.Rep. No. 91-552, 91st Cong., 1st Sess. 61 (1969), 2 U.S. Code Cong. & Adm. News 2090 (1969).

profit organization which is exclusively involved in the delivery of a particular service and which otherwise meets the organizational and operational requirements of the regulations.⁸⁴ If any such organization is operated for the benefit of private individuals as opposed to the public benefit, then it will not qualify for the exemption.⁸⁵ For example, in *Harding Hospital*⁸⁶ the District Court approved of the IRS position that the hospital in question was operated for the principal benefit of its physicians who also practiced psychiatry at the institution. Thus, by analogy to the standards for hospitals, any educational organization which fully recovered the cost of all services provided to its students would qualify for both exemption and charitable donee status if there is no inurement to a limited number of private individuals.⁸⁷

D. Business Activities and Legislative Responses

It is important to note that the issue of exemption and

84. Treas. Reg. § 1.501(c) (3)-1(d) (1959).

85. Treas. Reg. § 1.501(c) (3)-1(d) (1) (ii) (1959). To qualify as an exempt organization, I.R.C. § 501(c) (3) includes the restriction that "no part of the net earnings of which inures to the benefit of any private shareholder or individual."

86. *Harding Hospital, Inc. v. United States*, 358 F. Supp. 805 (S.D. Ohio), *aff'd*, 505 F.2d 1068 (6th Cir. 1974). *Accord*, *Sonora Community Hospital v. Commissioner*, 397 F.2d 814 (9th Cir. 1968) (hospital operated for private benefit of its original owners, rather than for the exclusive benefit of the public).

87. An otherwise qualifying nonprofit organization that purchases or leases at fair market value the assets of a former for-profit school and employs the former owners, who are not related to the current directors, at salaries commensurate with their responsibilities is operated exclusively for educational and charitable purposes. An organization that takes over a school's assets and its liabilities, which exceed the value of the assets and include notes owed to the former owners and current directors of the school, is serving the directors' private interests and is not operated exclusively for educational and charitable purposes. Rev. Rul. 76-441, 1976-46 I.R.B. 11.

88. *See, e.g., Cleveland Chiropractic College v. Commissioner*, 312 F.2d 203 (8th Cir. 1963) (where excessive compensation was found to violate this restriction).

continued qualification as a charitable organization depended initially on the purposes of the organization rather than its specific activities. When the question of qualification for exemption under the Income Tax Act of 1913⁸⁸ was first reached by the Supreme Court,⁸⁹ it involved the issue of whether a religious organization, which raised some of its funds from the sale of wine and chocolate, qualified as an organization which operated "exclusively" for religious and charitable purposes. In answering the question in the affirmative, the Court stated that:

Evidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain. Such activities cannot be carried on without money; and it is common knowledge that they are largely carried on with income received from properties dedicated to their pursuit. This is particularly true of many charitable, scientific, and educational corporations and is measurably true of some religious organizations. Making such properties productive to such end that the income may be thus used does not alter the purposes for which the corporation is created and conducted. This is recognized in *University v. People*, 99 U.S. 309, 324, where this court said: "The purpose of a college or university is to give youth an education. The money which comes from the sale or rent of land dedicated to that object aids this purpose. Land so held and leased is held for school purposes, in the fullest and clearest sense."⁸⁹

Thus, the test for qualification depended not so much on

88. See *Trinidad v. Sagrada Orden*, 263 U.S. 578 (1924). The IRS had adopted a very restrictive attitude toward commercial activities conducted by exempt organizations. See IX-2636, XI-2 C.B. 102 (1932); O.D. 953, 4 C.B. 261 (1921).

89. 263 U.S. at 581-82.

what specific activities an organization engaged in but rather whether its articles of incorporation (or similar organizational documents) limited its purposes to one or more of the specified exempt purposes. Two decades later, however, the Supreme Court held that the "presence of a single non-educational purpose, if substantial in nature," was sufficient to deny qualification for exemption.⁹⁰ This decision, as well as others,⁹¹ reaffirmed the view that the actual activities, whether or not commercial in nature, were unimportant in determining qualification for exemption. Accordingly, it was the stated purpose, not the economic reality of operations, that was the focus of the exemption question — a triumph of form over substance.

Thus, an obvious technique to avoid taxes was offered to pragmatic tax planners. They could provide that the organization's purposes were exclusively charitable or educational, yet engage in a regular commercial business, directly or indirectly through a subsidiary, and avoid any tax on the profits from the commercial enterprise.⁹² The IRS frequently

90. *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945). The exemption issue was raised in connection with a statutory exception for certain charitable and educational organizations from social security taxes. The decision is clearly analogous to the statutory exemption from federal income tax. In denying the organization's qualification for exemption, the Supreme Court stated:

In this instance, in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes . . .

326 U.S. at 283.

91. See, e.g., *Trinidad v. Sagrada Orden*, 263 U.S. 578 (1924).

92. For an excellent discussion of the difficulties created by the judicially approved commercial activities of tax-exempt organizations, see Eliasberg, *Charity and Commerce—Section 501(c) (3)—How Much Unrelated Business Activity*, 21 TAX L. REV. 53 (1965) [hereinafter cited as Eliasberg].

challenged such a technique for avoiding federal income taxation. A typical example of the IRS's unsuccessful attempts to defeat the effectiveness of this tax avoidance technique can be observed in *C.F. Mueller Co. v. Commissioner*.⁹³

In *Mueller*, a corporation was organized for exclusively charitable and educational purposes with all of its profits to be turned over to the New York University School of Law. After a corporate merger, the corporation owned and operated a macaroni manufacturing business. Nonetheless, the business was held to qualify for exemption from the federal income tax because all of its profits were turned over to an educational institution.⁹⁴ In reaching this decision, the Court of Appeals for the Third Circuit stated that:

The exclusive purpose required by the statute is met when the only object of the organization involved originally was and continues to be religious, scientific, charitable or educational, *without regard to the method of procuring the funds necessary to effectuate the objective* . . .⁹⁵

Other courts, faced with the exemption question where there were extensive commercial activities, began to limit the destination-of-income test.⁹⁶ For example, in *Ralph H. Eaton Foundation v. Commissioner*,⁹⁷ where the commercial operations of the foundation were substantial, the court denied exemption on the basis of a non-exempt purpose, i.e., to

93. 190 F.2d 120 (3d Cir. 1951). See *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938).

94. 190 F.2d at 121.

95. *Id.* (emphasis added).

96. See Eliasberg, *supra* note 92, at 64-74. The minority judicial view, prior to 1951, on the issue as to what effect commercial operations have on qualification for exemption is fully discussed in *University Hill Foundation v. Commissioner*, 446 F.2d 701, 704 (9th Cir. 1971).

97. 219 F.2d 527 (9th Cir. 1955).

operate a commercial enterprise.⁹⁸ This second approach focused on the nature of the organization's activities and the source of the income, and expressly rejected the destination-of-income test.⁹⁹ Such an approach was the basis of a new statutory provision which, instead of denying exempt status, declared a tax on the commercial income of an exempt organization.

1. Unrelated Trade or Business: 1950

Recognizing that a number of tax-exempt organizations were effectively shielding regular commercial income from taxation, Congress responded with a special provision in the Revenue Act of 1950.¹⁰⁰ This new provision created the term "unrelated business taxable income," which included any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational or other exempt purpose constituting the basis for its exemption under § 501. The primary purpose in subjecting commercial income of tax-exempt organizations to taxation was to eliminate "unfair competition."¹⁰¹ There were several other changes enacted as part of the Revenue Act of 1950, including the disallowance of the exemption of a separately incorporated subsidiary whose primary function was that of operating a business and turning the profits over to organizations exempt under § 501 (c) (3).¹⁰² Thus separately

98. *Id.* at 528.

99. See, e.g., *Riker v. Commissioner*, 244 F.2d 220, 230-35 (9th Cir. 1957); *United States v. Community Services, Inc.*, 189 F.2d 421, 424-25 (4th Cir. 1951); *Universal Oil Products v. Campbell*, 181 F.2d 451, 461 (7th Cir. 1950).

100. Revenue Act of 1950, ch. 994, § 301, 64 Stat. 947. Section 301 of this Act was the first provision to impose the unrelated business income tax on certain tax-exempt organizations.

101. S. Rep. No. 2375, Aug. 22, 1950, 2 U.S. Code and Congressional Service 3053, 3081 (1950).

102. Revenue Act of 1950, ch. 994, § 301, 64 Stat. 953.

incorporated organizations which claim exemption solely on the basis that their profits are turned over to a charitable organization would no longer qualify for exemption.

As a result of these innovative statutory reforms, the issues regarding exempt organizations changed to the following:

- (1) Whether the organization in question qualified for exemption;
- (2) If so, whether it was subject to unrelated trade or business income tax;¹⁰³
- (3) And if the organization was a subsidiary of an exempt organization, whether it too qualified for exemption on the basis that it also is exclusively engaged in fulfillment of charitable objectives or whether its primary purpose was to carry on a trade or business and turn the profits over to a charitable organization.¹⁰⁴

There were a number of other proposals enacted in the Revenue Act of 1950 affecting exempt organizations, such as the restriction against unreasonable accumulations¹⁰⁵ and the definition of prohibited transactions between a substantial

103. Not all exempt organizations were subject to the new tax; churches, a convention or association of churches were specifically excluded. Revenue Act of 1950, ch. 994, § 301, 64 Stat. 948, creating new § 421(b) of the Internal Revenue Code of 1939. It is interesting to point out that the IRS successfully took the position that the Christian Brothers were not a "church" and thus subject to unrelated business income tax on the profits from the sale of Christian Brothers Brandy. *De La Salle Institute v. United States*, 195 F. Supp. 891 (W.D. Calif. 1961).

104. S. Rep. No. 2375, Aug. 22, 1950, 2 U.S. Code and Congressional Service 3078 (1950). See § 301 of the Revenue Act of 1950, which provided in part that "an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt . . . on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation."

105. Revenue Act of 1950, ch. 994, § 321, 94 Stat. 956. The House Bill proposed to impose a tax on such accumulated income but the Conference Report decided to deny the exempt status of any

contributor and the charitable recipient of such contribution.¹⁰⁶ These matters will be briefly discussed below.

It is interesting to observe that the new unrelated trade or business tax and its application to the operations of colleges and universities were specifically addressed by the Senate Finance Committee. Its report stated in part:

Athletic activities of schools are substantially related to their educational functions. For example, a university would not be taxable on income derived from a basketball tournament sponsored by it, even where the teams were composed of students of other schools . . . In the case of an educational institution, income from dining halls, restaurants, and dormitories operated for the convenience of students would be considered related income and therefore would not be taxable. Income from a university press would be exempt in the ordinary case, since it would be derived from an activity that is "substantially related" to the purpose of the university.¹⁰⁷

This special reference in the legislative reports reveals that

organization for the year during which its accumulation was unreasonable. See Conference Report on H.R. 8920 (Revenue Act of 1950), 2 U.S. Code and Congressional Service 3198, 3216 (1950).

106. Revenue Act of 1950, ch. 994, § 331, 94 Stat. 958.

107. S. Rep. No. 2375, Aug. 22, 1950, 2 U.S. Code and Congressional Service 3053, 3082 (1950). The Conference Report noted that the issue of taxation on the profits of an unrelated trade or business for years prior to 1951, whether conducted directly or through a subsidiary, was in litigation and that the retroactive tax may cause undue hardship if such profits have already been spent in the pursuit of educational progress. Conference Report on H.R. 8920 (Revenue Act of 1950), 2 U.S. Code and Congressional Service 3198, 3214 (1950). Presumably, the Conference Report was referring to business-oriented organizations such as the one in *Mueller*. See notes 93-95 *supra* and accompanying text. In connection with the Revenue Act of 1951, the House Ways and Means Committee decided to recommend that an educational feeder organization should not be denied exemption for years prior to 1950 "if

colleges and universities were greatly concerned about the possible application of the new tax and, more importantly, *had effectively succeeded in communicating this concern to Congress.*¹⁰⁸ Furthermore, the Senate Finance Committee's observation that the usual activities of a college or university would be considered related to the educational institution's exempt purposes was more advantageous in many respects than a favorable tax ruling.

On the other hand, it should be noted that as to "unusual" business operations conducted by private colleges, the profits therefrom would be subject to the unrelated business tax. Since state universities, as instrumentalities of the state, were not exempt under § 501 (c) (3), they were not subject to the newly enacted tax. This created an obvious disparity of tax treatment between private and public institutions of higher learning which was remedied a year later when Congress specifically subjected state institutions to the same tax.¹⁰⁹

2. Extension of Unrelated Trade or Business: 1969

There were no significant congressional changes regarding the unrelated trade or business tax until the Tax Reform Act of 1969 when Congress expanded the scope of the provision. The change affected numerous tax-exempt organi-

their profits inure to a regularly established school, college or university." H.R. Rep. No. 586 (June 18, 1951), 2 U.S. Code and Congressional Service 1781, 1817 (1951).

108. It is doubtful that private colleges were ever better represented in the congressional tax hearings than they were during the development of the Revenue Act of 1950.

109. See S. Rep. No. 781 (Sept. 18, 1951), 2 U.S. Code and Congressional Service 1969, 1997 (1951), where it was noted "that some state schools are engaging in unrelated activities and 'lease-backs' which would be taxable if they were not a state or its instrumentality." The Conference Report accepted the Senate extension of the unrelated business tax to state schools. See Conference Report on H.R. 4473 (Revenue Act of 1951), 2 U.S. Code and Congressional Service 2121, 2138 (1951).

It might be added here that there still may exist a constitutional question as to the power of the federal government to tax a state instrumentality.

zations engaged in business activities which were not taxed under the Revenue Act of 1950. The Senate Finance Committee expressed its rationale for the unrelated business tax extension:

In recent years, many of the exempt organizations not now subject to the unrelated business income tax — such as churches, social clubs, fraternal beneficiary societies, etc. — have begun to engage in substantial commercial activity. For example, numerous business activities of churches have come to the attention of the Committee. Some churches are engaged in operating publishing houses, hotels, factories, radio and TV stations, parking lots, newspapers, bakeries, restaurants, etc. Furthermore, it is difficult to justify taxing a university or hospital which runs a public restaurant or hotel, or other business, and not tax a country club or lodge engaged in a similar activity.¹¹⁰

The imposition of an unrelated business tax on churches applies, for the most part, for taxable years beginning after 1976.¹¹¹

The other principal change effected by the Tax Reform

110. S. Rep. No. 91-552, 91st Cong., 1st Sess., 2 U.S. Code Cong. and Adm. News 2027, 2096 (1969). The changes discussed in the Senate Report were effected by amending I.R.C. §§ 511 and 512. See §§ 121(a), (b) and (c) of the Tax Reform Act of 1969, P.L. 91-172.

111. I.R.C. § 512 (b) (16). See S. Rep. No. 91-552, 91st Cong., 1st Sess., 2 U.S. Code Cong. and Adm. News 2097 (1969). Before the 1969 tax revision, churches were in a favored status since they were excluded from the unrelated trade or business income tax under the Revenue Act of 1950. See note 103 *supra*.

Despite the depth of religious commitment, religious organizations were not opposed to conducting profitable enterprises and participating in creative tax planning devices. See, e.g., *Louis Berensen*, 507 F.2d 262 (2d Cir. 1974) (sale of ladies' sportswear to Temple Beth Ami); *University Hill Foundation v. Commissioner*, 446 F.2d 701 (9th Cir. 1971) (where Loyola University operated a massive business holding through a subsidiary corporation); *Aaron Kraut*, 62 T.C. 420 (1974) (sale of stock to the Cathedral of Tomorrow).

Act of 1969 was directed at eliminating a skillfully developed tax device. Under § 512 (b), passive income such as dividends, rents and royalties were specifically excluded from the unrelated business tax. The statutory gap was fully tested in *Commissioner v. Clay B. Brown*,¹¹² where the taxpayers carefully planned a bootstrap sale of a sawmill and lumber business to the California Institute for Cancer Research with the intention of receiving capital gain treatment on the transfer. A bootstrap sale is the purchase of a business by using its future income in payment of the purchase price.¹¹³ After the sale, the Institute leased the entire business back to the taxpayer. The rental payment would be at the rate of 86% of the business profits; the Institute in return would apply 90% of this rental payment to the taxpayers in payment of the purchase price. If the rent was not subject to tax, it would be possible to avoid most of the tax on the business income and thus have more funds to retire the indebtedness incurred by the purchase. The Supreme Court, while noting the apparent abuse of the tax-exempt status and the economically weak substance of the transaction, held that it qualified as a sale for tax purposes and accordingly granted capital gains treatment to the sellers.¹¹⁴ In so deciding, the Court pointed out that the resolution of the bootstrap "loophole" should be left to the congressional scrivener:

The problems involved in the purchase of a going

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112. 380 U.S. 563 (1965). It should be noted that the income from a long-term lease (of more than 5 years) was specifically subject to the unrelated business tax. Section 301(a) of the Revenue Act of 1950, adding § 423 of the Internal Revenue Code of 1939 (now I.R.C. § 514). As noted by the Supreme Court, *Clay Brown* involved a short-term lease which was excepted from the statutory provision. 380 U.S. at 565-66.
113. The sale and leaseback (bootstrap acquisition of a business through its profits) was closely analyzed in a scholarly study by Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business*, 108 U. PA. L. REV. 623, 943 (1960). See generally Moore & Dohan, *Sales, Churches, and Monkeyshines*, 11 TAX L. REV. 87 (1956).
114. 380 U.S. at 572.

business by a tax-exempt organization have been considered and dealt with by Congress. Likewise, it has given its attention to various kinds of transactions involving the payment of the agreed purchase price for property from the future earnings of the property itself. In both situations it has responded, if at all, with precise provisions of narrow application. We consequently deem it wise to "leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications."¹¹⁵

Congress promptly responded by subjecting income derived by a tax-exempt organization from the debt-financed acquisition of a business to the unrelated business tax.¹¹⁶

The previous discussion may seem extremely technical to you: how could your college possibly be involved in the operation of an unrelated trade or business? There are many promoters who will have a "pitch" to make your school wealthy at little or no cost. In the area of commercial enterprises, you must be concerned with the issue of whether any of the college's activities constitute unrelated trade or business. This does not mean it is a bad deal *per se*, but it does mean that the total ramifications of any venture must be explored by your college's legal counsel before any new activities are undertaken.¹¹⁷

115. *Id.* at 579. The author, having heard the arguments before the Supreme Court, believes that the Government's conceptual argument of the degree of risk-shifting which is necessary for a sale to be effected for tax purposes was too abstract for reasonable application, both as to similar cases in the future and as to what constitutes a sale for other types of transactions.

116. I.R.C. § 514. See S. Rep. No. 91-552, 91st Cong., 1st Sess., 2 U.S. Code Cong. and Adm. News 2092 (1969).

117. The author recently received a call from a legal advisor to a charitable organization whose executive director had tentatively committed the organization to provide a substantial capital investment in a high risk venture in return for a share of the profits. If the deal was a rip-off, the organization's exemption could be attacked on the basis of private

E. Recent Representative Cases and Rulings Dealing with Colleges and Universities

Colleges and universities have traditionally qualified for exemption under § 501 (c) (3) as charitable and educational organizations. Nonetheless, responsible administrators still must consider whether their college or its subsidiary foundation may have any tax problems. With this question in mind, the author believes that it would be helpful to review a smorgasbord of tax cases and rulings dealing with various activities of private colleges.

The most significant private college tax case of recent years is *University Hill Foundation v. Commissioner*,¹¹⁸ where the Ninth Circuit Court of Appeals held that a foundation organized for the exclusive benefit of Loyola University did not itself qualify for exemption because it was engaged in the operation of an active business. The foundation constituted a "feeder" organization as defined by § 502, which by its enactment had overruled the destination-of-income test as the principal means to qualify for exemption. This new position meant that the income which had been earned by the foundation (\$1,984,000 of which had been previously turned over to the Loyola University and an additional \$4 million of accumulation) was now subject to the corporation tax.

Briefly discussed below are a number of representative tax cases and rulings dealing with the question of qualification for exemption under § 501 (c) (3) as an educational organization and with the possible application of the unrelated business tax as imposed by §§ 511 to 514 on business operations of such educational institutions.

Qualification for Exemption:

1. A separately incorporated organization which operates

inurement; if it was successful, it is likely that the profits would be taxable as unrelated trade or business income. After having been so advised, the charity decided to rescind the proposal.

118. 446 F.2d 701 (9th Cir. 1971).

both a campus bookstore and restaurant qualifies for exemption as an integral part of the university. Rev. Rul. 58-194, 1958-1 C.B. 240. See *Squire v. Students Book Corp.*, 191 F.2d 1018 (9th Cir. 1951).

2. However, where a separately incorporated organization operated a bookstore not as an integral part of the university, it did not qualify for exemption. See *Stanford University Book Store v. Helneray*, 85 F.2d 710 (D.C. Cir. 1936).
3. A cooperative college bookstore serving only faculty and students and refunding excess earnings to purchasers qualified for exemption. Rev. Rul. 69-538, 1969-2 C.B. 116.
4. The IRS was conducting a study of university print shops to ascertain whether, if separately incorporated, such organizations qualified for exemption; and if not, whether the profits from such enterprises constituted the operation of an unrelated trade or business.¹¹⁹ A religious organization was precluded from exempt status where the publication and sale of materials was the organization's primary activity. *Scripture Press Foundation v. United States*, 285 F.2d 800 (Ct. Cl. 1961).
5. Where the compensation paid to the college president was unreasonable, the private college forfeited its tax-exempt status. *Cleveland Chiropractic College v. Commissioner*, 312 F.2d 203 (8th Cir. 1963).
6. A private college does not participate in a political campaign by offering a political science course that requires students to participate in the campaign of

119. This study was to be conducted by the IRS as a result of an agreement to settle the tax issues of qualification for exemption or the imposition of unrelated business tax regarding the activities of the Oxford University Press. The author is not aware that this study has been completed or otherwise published. *Oxford University Press v. United States*, Docket Nos. 385-60; 285-62 (ct. cl.; stipulated dismissal filed on April 20, 1966).

candidates of their choice. Rev. Rul. 72-512, 1972-2 C.B. 246.¹²⁰

7. A student newspaper publication which adopted specific positions on political issues does not constitute attempts by such college or university to influence legislation or to participate in political campaigns. Rev. Rul. 72-513, 1972-2 C.B. 246.
8. A non-profit association of accredited educational institutions whose membership also includes several proprietary schools qualifies for exemption. Rev. Rul. 74-146, 1974-1 C.B. 129.
9. Private schools which discriminate on the basis of race do not qualify for exemption. *Coit v. Green*, 404 U.S. 997 (1971).¹²¹
10. The position of *Coit v. Green* has also been applied to church schools which refuse to accept any racial and ethnic groups. Rev. Rul. 75-231, 1975-1 C.B. 158.¹²²

Unrelated Trade or Business:

1. A university which operated a commercial television station was subject to unrelated business tax despite

120. Note the policy statement of the American Council on Education Guidelines as to attempts to influence legislation and/or intervention in political campaigns, reprinted in 1970 CCH Standard Federal Tax Reporter par. 6743 (June 21, 1970).

121. As discussed earlier, the Commissioner was required to accept this position in *Coit v. Green*. See notes 57-59 *supra* and accompanying text. The IRS was very slow in coming to that position although there were some signs of acquiescence. For example, in Rev. Rul. 67-325, 1967-2 C.B. 113, the IRS held that a recreational facility claiming exemption on the ground that it was dedicated to the community did not qualify for exemption where it practiced discrimination. The final concession of the Commissioner was stated in Rev. Rul. 71-447, 1971-2 C.B. 230, where the decision in *Coit v. Green* was accepted.

122. This position is presently being litigated. For a procedural attempt to prohibit revocation before litigation on the merits, see *Bob Jones University v. Commissioner*, 416 U.S. 725 (1974).

limited telecasts of educational programs. *See Iowa State University of Science and Technology v. Commissioner*, 500 F.2d 508 (9th Cir. 1974).¹²³

2. The operation of a dining room or cafeteria by a hospital or a museum does not constitute an unrelated trade or business. Rev. Rul. 74-399, 1974-2 C.B. 172; Rev. Rul. 69-268, 1969-1 C.B. 160
3. The profits from a university owned radio station and cinder block plant were held subject to the unrelated trade or business tax. Rev. Rul. 55-466, 1955-2 C.B. 266.
4. A vocational school's sale of items produced by its students was not subject to the unrelated business tax, but the sale of non-student products was subject to such tax. Rev. Rul. 68-581, 1968-2 C.B. 250.
5. Rents received by an educational institution for the occasional use of its meeting halls qualify as income to be excluded from the unrelated trade or business tax. Rev. Rul. 69-178, 1969-1 C.B. 158.
6. A school which annually rents its facilities (tennis courts, housing and dining) to an individual who conducts a tennis camp for ten weeks each summer is subject to unrelated business tax on the income derived therefrom. Rev. Rul. 76-402, 1976-42 I.R.B. 10.
7. Income derived from the selling of advertising space in an educational journal is specifically defined as an unrelated trade or business as a result of the Tax Reform Act of 1969. *See* § 513 (c) (3).¹²⁴

123. An organization which produces cultural and educational programs for public educational channels did qualify for exemption under I.R.C. § 501 (c) (3). Rev. Rul. 76-4, 1976-3 I.R.B. 19.

124. The IRS originally attempted to adopt this position through the issuance of regulations without the benefit of specific statutory authority. *See* Barlow, *The New Treasury Tax on Exempt Organization Advertising: A Postscript and a Preview*, in TAX PROBLEMS OF NONPROFIT ORGANIZATIONS 239 (1968). I.R.C. § 513 (c) (3) was enacted to remove the statutory uncertainty. General Explanation of

8. Research income derived by a college does not constitute income from unrelated trade or business. Rev. Rul. 54-73, 1954-1 C.B. 160. However, the matter of research income has been discussed more recently. The modified rule is that such research income will be subject to tax as unrelated business income if the data are withheld for a period of time for the exclusive benefit of the sponsoring organization's business interest. Other income relating to research which is immediately made available to the public is not subject to the tax. Rev. Rul. 76-296, 1976-32 I.R.B. 6.

Observations as to Business Activities and Tax Impact

What can be gleaned from even a cursory review of the representative tax issues is that many activities carried on, directly or indirectly, by a private college may be subject to tax if conducted by a profit oriented enterprise. In the end, whether the private college will be subject to tax on the profit of a certain business (or its spin-off corporation created to conduct the same enterprise) depends on two basic facts:

- (1) Are the activities beyond those customarily associated with the delivery of education; and
- (2) Are there substantial profits derived from its operation?

If the answer to both of these questions is in the affirmative, it is likely that either such income will be subject to tax or the spin-off corporation will not qualify for exemption.¹²⁵ This clearly suggests that all innovative business activities which involve either significant investment or the likelihood of producing profits should be closely reviewed by your college's legal counsel. In this way, you can be assured of reducing both the threat to your college's qualification for

the Tax Reform Act of 1969, P.L. 91-172, Staff of the Joint Committee on Internal Revenue Taxation 73 (1970).

125. *University Hill Foundation v. Commissioner*, 446 F.2d 701 (9th Cir. 1971) is an example of the typical spin-off corporation of a private college which failed to qualify for exemption.

exemption and the possibility of certain income being subject to the unrelated business tax.

F. Private Foundations

Each generation questions anew the legal preferences accorded to the wealthy family charitable trusts, commonly referred to as private foundations.¹²⁶ Since wealth ultimately generates political power, private foundations whose inherent identity is wealth have created political and social conflict. When this occurs, the charitable shield is often promptly pierced and the ploys of its creators are mocked by those opposed to its views or activities.¹²⁷ The supporters of private foundations will, of course, stress the importance of private philanthropy and appropriately praise all the related benevolent ideologies.¹²⁸ The final outcome, as in a tug-of-war, will

126. For the definition of foundation before the enactment of I.R.C. § 509, see Comment, *The Modern Philanthropic Foundation: A Critique and a Proposal*, 59 YALE L.J. 477, 477 (1950), which stated that:

The foundation represents a new technique available to individuals who wish to devote their surplus wealth to public purposes. Unlike such traditional charitable institutions as hospitals, churches, and schools, which conduct activities directly beneficial to the public, philanthropic foundations confine most of their activities to grants in aid to other charitable institutions or endeavors.

Foundations are generally endowed with securities or land; and since foundation disbursements are typically made out of income earned by this wealth, endowments must be sizeable if disbursements are to be effective. Moreover, the majority of foundations receive their total endowments from a single person, family or business group.

See also F. ANDREWS, PHILANTHROPIC FOUNDATIONS 11-13 (1956); TREASURY REPORT ON PRIVATE FOUNDATIONS; 89th Cong., 1st Sess. (1965)

127. During a Senate investigation of industrial strife, charges were made by witnesses that many business - dominated foundations were exerting conservative influences. F. ANDREWS, PHILANTHROPIC FOUNDATIONS 342-343 (1956).
128. For a further discussion of this point, see the summary of the

depend on the political strength of the competing parties which, in view of the foundations' wealth, elegant representatives and expert counsel, will likely be in favor of the private foundations.

During those periods when the private foundations have been the subject of congressional investigation, the traditional antagonist has been the Commissioner of the IRS. Inherent in this process is the assumption that the IRS is the ideal agency to regulate private foundations. Little attention has been focused on this fundamental assumption;¹²⁹ thus the political strength or weakness of foundations has been essentially reflected in our fluctuating tax laws.

The current significant restrictions imposed on private foundations reflect the cumulative attitudes developed

testimonies of witnesses appearing before the Senate Finance Committee in 1969 in *FOUNDATIONS AND THE TAX BILL* (1969). Many representatives of private institutions of higher learning opposed the imposition of tax burdens on private foundations. Typical of their view was the testimony of Rev. Theodore M. Hesburgh, President, University of Notre Dame, who stated in part:

We are deeply concerned both about the proposed tax on foundation investment income and about the adoption of any mechanism whose effect would be to terminate the existence or exemption of all foundations over a period of time. Our combined experience with foundations convinces us that their work has been of immense value to the classes of institutions which we represent and to the American society.

Id. at 78.

129. Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 1968 U. SO. CAL. TAX INST. 27, 63. While Professor Stone does not question the obligation of the federal government to regulate private foundations, he does suggest that perhaps there should be a new agency specifically designed to deal with the problems of exempt organizations. As he stated in part:

While the Service has in recent years made heroic efforts to increase its auditing activities in this area, it remains better suited to raising revenue than to supervising the administration of wealth and charity. The Internal Revenue Service would probably not disagree with this

through a series of major congressional investigations.¹³⁰ The Revenue Act of 1950 offered modest reforms by establishing "prohibited transactions" between a tax-exempt organization and its creator as well as mandating that a tax-exempt organization may not unreasonably accumulate income.¹³¹ These restrictions were claimed to be insufficient by the late Representative Wright Patman in a series of reports issued by the House Subcommittee on Foundations of the Select Committee on Small Business.¹³² It is not unreasonable to believe that the investigatory blitz and aggressive accusation of foundation abuses by Representative Patman strongly

conclusion. On the other hand, because the interest of the Federal Government stems largely from the tax benefits granted, the federal power in this area should probably remain within the Treasury Department. This then may call for the creation of a separate division within the Treasury Department.

Id.

130. After the initial charges as to abuses by foundations in 1916, *see* note 127 *supra*, the next major study was an investigation of the investment activities of large foundations which were carefully manipulated for the business purposes of Textron, Inc. Hearings before the Subcommittee of Commerce on Interstate and Foreign Commerce, U.S. Senate, 80th Cong., 2d Sess. (1948); and S. Rep. No. 101, 81st Cong., 1st Sess. (1949). These investigations were soon followed by the Cox Committee of the House of Representatives in 1952. Final report of the Select Committee to Investigate Foundations and Other Organizations, H.R. Rep. No. 2514, 82d Cong., 2d Sess. (1953). Dissatisfied with that report, one representative, B. Carroll Reece, conducted further investigations which appear to be consistent with the atmosphere of the McCarthy era and focused on the alleged un-American educational views of foundations and other tax-exempt organizations. Report of the Special (Reece) Committee to Investigate Tax-Exempt Foundations, H.R. Rep. No. 2681, 83d Cong., 2d Sess. (1954). *See generally* F. ANDREWS, PHILANTHROPIC FOUNDATIONS 342-351 (1956).
131. *See* § 321 (a) of the Revenue Act of 1950, P.L. No. 814, adding §§ 162 (g) (2) (B) and 162 (g) (2) (F) (4) to the Internal Revenue Code of 1939. These became §§ 503 and 504 under the Internal Revenue Code of 1954.
132. Chairman of the House Select Committee on Small Business, Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy, 87th Cong., 2nd Sess. (three reports dated respectively Dec. 31, 1962; Oct. 16, 1963; and Mar. 20, 1964).

influenced the changes ultimately effected in the Tax Reform Act of 1969.¹³³

In essence, the principal abuses charged to foundations have been that huge amounts of wealth were not subject to tax and that such wealth was being applied to some extent for the personal commercial benefit of its creators, e.g., by aiding retention of control over closely held corporations. In addition, many have claimed that the amount of income actually applied to charitable purposes was clearly insufficient and the delay before such delivery completely unacceptable. A treasury report summarized the criticisms of private foundations in the following fashion:

Three broad criticisms have been directed at private foundations. It has been contended that the interposition of the foundation between the donor and active charitable pursuits entails undue delay in the transmission of the benefits which society should derive from charitable contributions; that foundations are becoming a disproportionately large segment of our national economy; and that foundations represent dangerous concentrations of economic and social power.¹³⁴

The remedy advocated by the Treasury Department was not to terminate these foundations, as threatened by Rep.

133. One authority remarked that:

The report, despite its blunt invective and frequent emotionalism, is very likely to have far-reaching practical, if not legal, consequences in the law and ethics relating to tax-exempt foundations, and charitable trusts.

Rieker, *Foundations and the Patman Report*, 63 MICH. L. REV. 95, 95 (1964).

A treasury report, issued in 1965, outlines some of the statutory changes eventually adopted by Congress. TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS, 89th Cong., 1st Sess. (Feb. 2, 1965).

134. TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS, 89th Cong., 1st Sess. 5 (1965).

Patman, but to propose a series of complex tax statutes to eliminate the specific abuses of private foundations.¹³⁵ These recommendations were substantially accepted by Congress as a major part of the Tax Reform Act of 1969.¹³⁶

The final impact of these tax statutes on the creation of new foundations and the continuation of existing foundations is not completely clear. It is quite conceivable that, except for foundations created by will, the result will be a substantial reduction in the number of new foundations due to the administrative cost necessary to deal with the statutory complexities. Some believe that the 1969 restrictions will have the effect of a "birth control pill" on the creation of new private foundations.¹³⁷ In addition, there will probably be a corresponding decrease in the number and amount of charitable contributions to private foundations due to the statutory restrictions imposed by the Tax Reform Act of 1969.¹³⁸

To the extent that there will be a reduction of contributions to new or existing private foundations, will those potential donors be inclined to continue to give to public charities, including colleges, at the same rate? Even if there is a reduction in the amounts donated to charities, is it possible

135. *Id.* at 5-10.

136. Sections 101 (a) and (b) of the Tax Reform Act of 1969, P.L. 91-172, enacting §§ 4940 (imposing 4% excise tax on investments); 4941 (prohibiting self-dealing between foundation and its creator or other disqualified person); 4942 (imposing excise tax sanctions for failure to distribute income or a stated percentage of its assets for charitable use); 4943 (imposing tax on excess business holdings); 4944 (imposing an excise tax on high-risk investments); and 4945 (imposing an excise tax on specified expenditures). For explanatory overview of these complex statutes, see General Explanation of the Tax Reform Act of 1969, P.L. 91-172, H.R. 13270, 91st Cong., 1st Sess., Staff, Joint Committee on Internal Revenue Taxation (1970).

137. Labovitz, *The Impact of the Private Foundation Provisions of the Tax Reform Act of 1969: Early Empirical Measurements*, 3 J. LEGAL STUDIES 63, 102 (1974).

138. *Id.*

that there will be a net increase in assets transferred to private colleges? These are important issues for private colleges and their representatives to consider.

Obviously there needs to be a study of the practices of major contributors and the degree to which the tax code encourages such persons to make charitable gifts, as well as in what amount and to which organizations.¹³⁹ Apart from these important questions, are institutions of higher learning willing to consider opposing the continuation of private foundations. In the alternative, will they lobby for increasing the required percentage of income pay out imposed on the private foundations,¹⁴⁰ based on the theory that educational institutions would be the likely recipients of either the corpus or income from such private institutions.¹⁴¹ Questions of this nature appear to be founded on an ill-defined self interest; yet contingent considerations and the lack of funds should prompt the private colleges to seek future security.¹⁴² It is manifest that future changes in the tax code will have a dramatic effect on the amounts of contributions to private colleges, particularly the smaller educational institutions whose vulnerability is so apparent. Are representatives and associations of private

139. *Id.*

140. The minimum payout was recently *reduced* to a maximum of 5% of the value of a private foundation's non-charitable assets. Section 1303 of the Tax Reform Act of 1976, amending I.R.C. § 4942 (e). See H. Conf. Rep. No. 94-1515, 9A U.S. Code Cong. & Adm. News 1222, 1325 (1976).

141. See the testimony of Peter G. Peterson, Chairman, Commission on Foundations and Private Philanthropy, before the Senate Finance Committee on the Tax Reform Act of 1969, 91st Cong., 1st Sess. 6137 (1969). He indicated that at least 96% of the 85 donors, who had given over \$375,000 over the last five years, felt that a repeal of the charitable deduction would reduce contributions significantly, with the median reduction to be about 75%.

142. It is noteworthy that substantial contributors strongly favor educational institutions of higher learning. Approximately 45% of such contributors were estimated by the Peterson Commission to make contributions to educational institutions.

colleges ready to seriously reexamine their basic assumptions as they seek to secure unencumbered funds for continued growth? There is no doubt that the enactment of the private foundation restrictions in 1969 has directly enhanced your college's status as a potential recipient of substantial funds from wealthy families. Are you willing to argue for another turn of the tax screw against private foundations.¹⁴³ It may sound diabolic to ask these questions, but each turn may affect your ultimate quest for survival and future growth.

143. There are, of course, many outstanding examples of private foundations funding various important activities or research projects of private colleges. For a brief discussion of the relationship of private foundations and education, see F. RUDOLPH, *THE AMERICAN COLLEGE AND UNIVERSITY: A HISTORY* 430-34 (1962).

II.

CHARITABLE DEDUCTION

A. Purposes

While § 170 (c) of the Internal Revenue Code seems identical to § 501 (c) (3), it provides a radically different function in that a tax deduction is granted for contributions of property to charitable organizations as defined therein. In essence, through a tax reduction the federal government provides a subsidy to those individuals and corporations that make contributions of property to qualifying charitable organizations. Professor McDaniel succinctly describes the process of the charitable contribution:

The matter can be put this way: The deduction for charitable contributions is simply a mechanism whereby the federal government matches private donations to charity. For example, if a 70% bracket taxpayer wishes to give \$100 to charity, the deduction system matches a \$30 gift by the taxpayer with \$70 of federal funds. The taxpayer is denominated the paying agent for the government's share and is given the right to designate where that share will go. The taxpayer writes only one check to charity; but this does not change the fact that it is in reality two checks - one representing his own private gift of \$30 and the other the government's matching contribution of \$70.¹⁴⁴

This was precisely what Senator Hollis wished to accomplish when he offered the proposal for a charitable

144. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Reduction*, 27 TAX L. REV. 377, 379 (1972). See generally Bittker, *Charitable Contributions: Tax Reductions or Matching Grants?*, 28 TAX L. REV. 37 (1973).

deduction from the Senate floor in 1917;¹⁴⁵ the war and increased taxes had an obviously unfavorable impact on charitable contributions which could be mitigated by this indirect subsidy to encourage continued contributions.¹⁴⁶

B. Filer Commission Report

In the most recent and outstanding study of the function of the charitable deduction by the Filer Commission, it was stated that:

Potentially the most serious challenge to the system of tax immunities affecting nonprofit activity concerns — directly and indirectly — the charitable deduction under the federal personal income tax, *which influences by far the largest source of private giving to nonprofit organizations, giving by individuals.*¹⁴⁷

The Filer Commission study provides a perceptive review of the tax code and its impact on giving. Clearly, the most important facet is the effect of § 170. A reduction of the amounts deductible or an outright repeal (without an alternative federal support system) would probably force the termination of many charitable organizations whose income life blood depends on future contributions.

Among the more important recommendations of the Filer Commission were:¹⁴⁸

145. The provision permitting the taxpayer to deduct a contribution from his personal income tax was first enacted in 1917, with the qualification that the recipient be exclusively organized for religious, educational, or charitable purposes. Act of Oct. 3, 1917, ch. 63, § 1201 (2), 40 Stat. 330.

146. Committee on the Budget of the United States Senate, Tax Expenditures, 94th Cong., 2d Sess. 92 (1976). See H.R. Rep. No. 172, 65th Cong., 1st Sess.; Tax Expenditures, 94th Cong., 2d Sess. 92 (1976).

147. FILER COMMISSION REPORT, *supra* note 5, at 106.

148. *Id.* at 18-27.

1. The charitable deduction should not only be retained but expanded;
2. Taxpayers who take the standard deduction (who do not itemize) should nevertheless be entitled to claim, in addition, special deductions for charitable contributions. In order to do this, the present statute must be modified to allow charitable deductions in addition to the standard deduction.
3. That taxpayers with gross incomes between \$15,000 and \$30,000 should be able to claim a charitable deduction for one and one-half times the actual amount contributed, and that where the taxpayer has an income less than \$15,000, the deduction should be twice the actual amount of the charitable contributions.

These and other recommendations of the Filer Commission are quite provocative and, if adopted, would further induce charitable contributions. The report estimated that by establishing the charitable deduction as an addition to the standard deduction, an additional sixty million taxpayers would be able to benefit by making such contributions.¹⁴⁹ Part of the reason for this result is that the number of persons who itemize has decreased due to the larger standard deduction over the last few years. One economic analysis of this proposal estimates that the amount of charitable contributions would be increased by \$1.9 billion in 1976 alone.¹⁵⁰

Some of the changes recommended by the Filer Commission Report regarding charitable deductions have already occurred in connection with other provisions of the Internal Revenue Code.

In the Tax Reform Act of 1976 there were two modifications which are precisely the type the Commission recommended. The first change was that of making alimony

149. *Id.* at 136.

150. *Id.*

payments into a § 62 deduction, which allows the payment to be a deduction from gross income rather than as an itemized deduction.¹⁵¹ The other change is much more dramatic. The expenses for child care, which were previously an itemized deduction, have been granted the high status of a tax credit.¹⁵⁶ In many respects, the political consciousness of women can be traced in the federal tax structure from the original judicial disallowance of a child care deduction in 1939¹⁵³ to that of a limited itemized deduction, and then finally to the status of a tax credit.

The same favorable development can occur with respect to the charitable deduction. The Filer Commission has spoken. One wonders how many private college administrators have studied this valuable report and are reasonably conversant with its exciting and provocative suggestions for action. Whether a successful extension of the charitable deduction will occur involves simply a question of the political effectiveness of private colleges and other charitable organizations. In view of the reported decrease of \$80 million in contributions last year to educational institutions,¹⁵⁴ what greater evidence of the emergency needs to be pointed out to private college administrators?

151. See § 502 of the Tax Reform Act of 1976, P.L. 94-455, enacting I.R.C. § 62 (13).

152. See § 504 of the Tax Reform Act of 1969 repealing I.R.C. § 214.

153. See H.C. Smith, 40 B.T.A. 1038 (1939), *aff'd without opinion*, 113 F.2d 114 (2d Cir. 1940). The Board of Tax Appeals in arriving at its decision stated very outdated notions when it explained: "We are not prepared to say that the care of children like similar aspects of family and household life, is other than a personal concern. The wife's services as custodian of the home and protector of its children are ordinarily rendered without monetary compensation." 40 B.T.A. at 1039.

154. Scully, "Voluntary Support of Colleges Drops \$80 Million in Year," *The Chronicle of Higher Education*, Mar. 29, 1976, at 5, col. 1. The Council of Financial Aid to Education estimated that donations from all sources amounted to \$2.16 billion in the year ending last June 30. Also note President Ford's proposed budget reduction of \$1.5 billion in aid to higher education for fiscal year beginning Oct. 1, 1977. Fields,

C. Tax Expenditures

While the Filer Commission report struggles for political support like a grape desiring to turn to wine,¹⁵⁵ there has developed a widespread congressional acceptance of the "tax expenditures" concept.¹⁵⁶ A tax expenditure has been defined as:

The cost to the Federal Government, in terms of revenues it has foregone, of tax provisions that either have been enacted as incentive for the private sector of the economy or have that effect even though initially having a different objective. The tax incentives usually are designed to encourage certain kinds of economic behavior as an alternative to employing direct expenditures or loan programs to achieve the same or similar objectives. These provisions take the form of exclusions, deductions, credits, preferential tax rates, or deferrals of tax liability.¹⁵⁷

"For Higher Education: \$1.5 Billion Less," *The Chronicle of Higher Education*, Jan. 26, 1976, at 5, col. 1. But there was some good news in terms of revenue for colleges and universities. Magarell, "College Finances Are Looking Better," *The Chronicle of Higher Education*, Feb. 17, 1976, at 9, col. 1.

155. One of its recommendations regarding attempts to influence legislation was accepted in the Tax Reform Act of 1976. Section 1307 of the Tax Reform Act of 1976, enacting I.R.C. §§ 504 and 4911.
156. The tax expenditure concept was developed by Professor Stanley S. Surrey while he was Assistant Secretary for Tax Policy. See Surrey, *Federal Income Tax Reforms: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 528 (1970); Surrey & Hellmuth, *The Tax Expenditure Budget — Response to Professor Bittker*, 22 NAT. TAX. J. 528 (1969); Bittker *The Tax Expenditure Budget — A Reply to Professors Surrey and Hellmuth*, 22 NAT. TAX. J. 538 (1969). The approach of Professor Surrey was accepted as part of the Congressional Budget and Impoundment Act of 1974, P.L. 93-344.
157. Committee on Ways and Means, March 15 Report of the House Ways and Means Committee to the House Budget Committee, 94th Cong., 2d Sess. 29 (1976). While the idea of a tax expenditure is helpful, the author

In future discussions as to the merits of tax expenditures, the issue of charitable deductions will always be near the top of the list for review. This is particularly true because of its present irrational result, i.e., the richer the person is the lower the cost of giving because of the income tax rates.

In reviewing the charitable deduction, the Senate Budget Committee arrived at the following estimates of the cost of tax expenditures of the charitable contributions to the federal government:

(in millions of dollars) ¹⁵⁸					
Fiscal Year	Individual		Corporations		Total
	Education	Other	Education	Other	
1977	500	3,955	380	525	5,260
1976	450	3,820	215	395	4,880
1975	440	4,385	205	385	5,415

In its report, the Senate Budget Committee concluded "that the deduction increases charitable giving by more than the foregone Treasury Revenue, and that it *favors educational contributions relatively more than a tax credit or matching grant outside the tax system.*"¹⁵⁹ Thus, the tax expenditures tool as presently applied specifically to charitable contributions to education does not suggest revision or modification. In fact, the present conclusion is in favor of its continuation and

is not certain that it is radically different from the earlier tax perjuries such as loopholes and tax erosion.

158. Committee on the Budget of the United States Senate, Tax Expenditures, 94th Cong., 2d Sess. 92 (1976). It is interesting to note a small decrease in the estimated cost from 1975 to 1976; this could be due to several factors such as slight decreases in income, the decrease in contributions, and certain tax reductions of the last two years. The estimates are confirmed by the reported loss in contributions to educational institutions. See note 154 *supra*.

159. Committee on the Budget of the United States Senate, Tax Expenditures, 94th Cong., 2d Sess. 92 (1976). This may explain in part why Senator Muskie opposed the college tuition tax credit. See 122 Cong. Rec. 13,567 (daily ed. Aug. 5, 1976).

perhaps even its expansion. In any event, the issue of charitable deductions will remain volatile and subject to change, requiring constant vigil by the representatives of private colleges.

D. Review of Current Rules

Section 170 of the Internal Revenue Code has gradually evolved into a number of rules as to the extent to which contributions of property to particular organizations qualify as charitable deductions.¹⁶⁰ The rules are generally modified to reflect the current belief as to the function of the charitable deduction.¹⁶¹ Although the rules undergo constant change, it is still important that the private college administrator has a basic understanding of the scope and application of the charitable deduction for income, estate and gift tax purposes.¹⁶²

The basic charitable deduction rules raise several questions, such as (1) who may claim the deduction, (2) how much is deductible (there is a percentage limitation and different rules for the contribution of various types of property), and (3) what are the specific requirements to claim a

160. A qualifying organization is defined by I.R.C. § 170 (c), which is identical in terms to I.R.C. § 501 (c)(3). The IRS maintains a private list of all exempt organizations on its Exempt Organizations Master File (EOMF). In the 1975 fiscal year, over 690,000 organizations were listed on that master file. See Annual Report 1975, Commission of Internal Revenue 41 (1975). The IRS also maintains a list of those organizations which qualify as a charitable donee for purposes of I.R.C. § 170 (c). See I.R.S. Pub. No. 78, Cumulative List of Organizations. The attorney General of Ohio also publishes a directory of charitable foundations. CHARITABLE FOUNDATIONS DIRECTORY OF OHIO (2d ed. 1975). This document may provide some suggestions for sources of possible grants.

161. See generally Bittker, *Charitable Bequests and the Federal Estate Tax: Proposed Restrictions on Deductibility*, 115 TRUSTS & ESTATES 532 (1976).

162. For an excellent discussion of the rules regarding charitable deductions see S. GOLDBERG, *TAXATION OF CHARITABLE GIVING* (1973).

deduction for the gift of a future interest. The answer in particular cases may be much more complicated than a brief overview of these rules would indicate. There is no attempt here to make you an expert regarding the charitable deduction rules but rather to provide you with an introduction to this important area.

1. Percentage Limitations

Both individuals and corporations may claim a deduction for the contribution of "property" to a qualified charitable organization. There is, however, no deduction allowed for the contribution of services.¹⁶³ In addition, an individual is limited in the amount that he can claim for a deduction in any taxable year. For contributions to such organizations as churches, medical research centers and educational institutions, a person may deduct up to 50% of his adjusted gross income.¹⁶⁴ If the contribution is to a private foundation, then an individual may deduct only up to 20% of his adjusted gross income.¹⁶⁵ Corporations, on the other hand, may deduct up to 5% of their taxable income.¹⁶⁶ Where an individual makes contributions in excess of the 50% ceiling to the charitable organization, he may carry forward the disallowed excess contribution over the next succeeding five taxable years.¹⁶⁷ There is also a similar excess carry-over provision for corporations.¹⁶⁸

163. Treas. Reg. § 1.170A-1 (q). Where personal unreimbursed expenditures are incurred for the benefit of a charitable organization, those expenses may be deductible if substantiated by appropriate records.

164. I.R.C. § 170 (b) (1) (A).

165. I.R.C. § 170 (b) (1) (B). The 50% limitation also applies to a private "operating" foundation as described in I.R.C. § 4942 (j) (3) and to a private foundation under certain circumstances. See I.R.C. §§ 170 (b) (1) (A) (vii) and 170 (b) (1) (E).

166. I.R.C. § 170 (b) (2).

167. I.R.C. § 170 (d) (1) (A).

168. I.R.C. § 170 (d) (2) (A).

2. Capital Gain Property

Apart from the percentage limitations, there are specific rules as to the valuation of the property contributed. Where the property contributed would qualify for capital gains purposes if sold, then the asset is valued on the basis of its fair market value.¹⁶⁹ The contribution of capital gain property invokes another limitation of 30% of adjusted gross income but again there is a five year carry forward period.¹⁷⁰ Hence, whether the property contributed is a capital asset as defined by the Code is crucial in determining the amount deductible.

3. Ordinary Income Property

If the gain on the sale of the property contributed would be taxed as ordinary income, then only the adjusted basis of the property contributed will qualify for the purpose of determining the amount which would be deductible.¹⁷¹ The different treatments for contributed property, which depend upon whether its sale would produce capital gain or ordinary income, did not long remain an academic question. This precise issue became the focus of an intense examination of former President Nixon's gift of personal papers during his 1969 taxable year. The Joint Committee on Internal Revenue Taxation, in its report on President Nixon's tax returns, explained the new statutory provision:

In 1969, the Congress passed and the President signed, the Tax Reform Act of 1969 which contained amendments which, in effect, repealed provisions of the Internal Revenue Code allowing charitable deductions for gifts of paper. The 1969

169. See I.R.C. § 170 (e) (1); Treas. Reg. § 1.170A-1 (c) (1).

170. I.R.C. § 170 (b) (1) (D). There is no carryover where the 20% limitation applies for individuals. See I.R.C. § 170 (d) (1). There is a limited exception to the 30% restriction if a special election is made. I.R.C. § 170 (b) (1) (D) (iii).

171. I.R.C. § 170 (e).

Act repealed these provisions retroactively as of July 25, 1969. This had the effect of allowing a charitable contribution deduction for gifts of papers if they were made on or before July 25, 1969, but not if they were made after that date. The question has arisen whether the gift of papers for which President Nixon claimed a deduction was completed prior to July 25, 1969.¹⁷²

In finding that the gift had in fact occurred after the critical date, the Joint Committee recommended that the charitable deductions of \$482,018 taken during the tax years from 1969 to 1972 should be denied.¹⁷³

4. Tangible Personal Property

A special rule applies when tangible personal property is given to a charitable organization. If the potential use is unrelated to the organization's exempt purposes, then one-half of the capital gain is reduced from the fair market value to determine the amount deductible.¹⁷⁴ The Treasury regulations provide the following example:

If a painting contributed to an educational institution is used by that organization for educational purposes by being placed in its library for display and study by art students, the use is not an unrelated use; but if the painting is sold and the proceeds used by the organization for educational purposes, the use of the property is an unrelated use . . .¹⁷⁵

172. Examination of President Nixon's Tax Returns for 1969 through 1972, prepared for the Joint Committee on Internal Revenue Taxation, 93rd Cong., 2nd Sess. 9 (1974) [hereinafter cited as Nixon's Tax Returns].

173. *Id.* at 5. For a clear example of this important distinction, see example (1) of Treas. Reg. § 1.170A-4 (d).

174. I.R.C. § 170 (e) (1) (B).

175. Treas. Reg. § 1.170A-4 (b) (3).

There are other similar reductions when capital gain property is given to a private foundation.¹⁷⁶

5. Future Interests

A significant but complex rule has been established for the charitable deduction of a future interest.¹⁷⁷ To obtain such a deduction, it must be in the form of an annuity trust, unitrust or pooled income fund.¹⁷⁸ These provisions have been so little understood that Congress has extended the effective date for the estate tax charitable deduction on two separate occasions; the latest extension was granted in the Tax Reform Act of 1976.¹⁷⁹

The qualifications for a charitable deduction on a transfer of a future interest are very technical;¹⁸⁰ it clearly calls for the assistance of tax counsel. In essence, a charitable remainder annuity trust is a transfer in which one or more persons have a life estate to be paid a certain sum (not less than 5% of the value of the assets transferred) with the remainder interest going to a named charity.¹⁸¹ A charitable remainder unitrust is quite similar except that the life estate beneficiaries are paid a fixed percentage (not less than 5%) of the value of the assets as determined each year (the beneficiary's interest each year rides up with appreciation and down with depreciation), with the remainder interest going to charity.¹⁸² A charitable deduction

176. I.R.C. § 170 (e) (1) (B) (ii).

177. I.R.C. § 170 (f) (2). The future interest rule does not apply to a gift of a remainder interest in a personal residence or farm. I.R.C. § 170 (f) (3) (B) (i).

178. I.R.C. § 170 (f) (3) (B) (i).

179. Section 1304 of the Tax Reform Act of 1976 amended I.R.C. § 2055 (e) (3) by extending the date to amend charitable remainder trust governing instruments to December 31, 1977.

180. See, e.g., Rev. Rul. 76-445, 1976-46 I.R.B. 18; Rev. Rul. 74-19, 1974-1 C.B. 155.

181. I.R.C. § 664 (d) (1).

182. I.R.C. § 664 (d) (2).

is provided for the value of the remainder interest in both the annuity and unitrust transfers, according to Treasury regulations.¹⁸³ A failure to meet any of the statutory technicalities will likely result in a complete forfeiture of any charitable deduction.¹⁸⁴

A pooled income fund is significantly different in that the charity itself establishes a common trust fund in which contributed assets are commingled.¹⁸⁵ The donor retains a life interest in the income of the contributed funds and is given a charitable deduction for the remainder interest, valued in accordance with the applicable regulations.¹⁸⁶ Obviously, a private college would want to fully explore the pros and cons, with the advice of counsel, before deciding to create such a fund.

6. Estate and Gift Tax Charitable Deductions

There are no limitations imposed on the amounts qualifying for charitable deduction under § 2055 for estate tax purposes or under § 2522 for gift tax purposes. The only real technicality relates to testamentary transfers of a charitable remainder interest where, like the rules for income tax purposes, the transfer must qualify as an annuity trust, unitrust or to a pooled income fund.¹⁸⁷

Perhaps the most important aspect of the charitable deduction for estate tax purposes is the impact of the newly enacted estate tax revisions on future testamentary charitable bequests.

183. Treas. Reg. § 1.664-4 and Tables A and E.

184. For an excellent discussion of techniques to deal with defective charitable remainder transfers for tax purposes, see Ibach & Lehrfield, *Dysfunctions in Deferred Giving*, 113 TRUSTS & ESTATES 372 (1974).

185. I.R.C. § 642 (c) (5).

186. Treas. Reg. § 1.642 (c)-6 and Table G.

187. I.R.C. § 2055 (c).

As a result of the revisions, the estate tax will be significantly decreased for estates between \$200 to \$500 thousand dollars, due to substantial increases in the exemption (in the form of a tax credit) and in the allowable marital deduction.¹⁸⁸ Like the standard deduction for income tax purposes,¹⁸⁹ the incentive to make testamentary charitable bequests decreases as the estate tax benefits are reduced. The testator in many situations will now have a choice between leaving his property to his family or to charity, rather than to the United States in the form of taxes or to a charity. Obviously, in light of the recent changes, the testator will favor his family rather than the charity in the future.

E. Valuation of Property

Often the principal issue regarding a charitable deduction is the factual question as to the fair market value of the transferred asset. The standard for determining fair market value is stated in the Treasury regulations as:

The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.¹⁹⁰

Where, for example, listed securities are transferred, generally the value will be the same as that for estate and gift tax purposes, i.e., the average between the highest and lowest selling prices on the day in which the stock is given to the charity.¹⁹¹ If the stock transferred is that of a closely held

188. See §§ 2001 and 2002 of the Tax Reform Act of 1976. For a discussion of these amendments, see H. Conf. Rep. No. 94-1515, 9A U.S. Code Cong. & Adm. News 1350-67 (1976). In this report, the amount of revenue loss due to these changes was estimated to be \$1.4 billion by 1981. *Id.* at 1386.

189. See text at notes 149-50 *supra*.

190. Treas. Reg. § 1.170A-1 (c) (2).

191. Treas. Reg. § 20.2031-2 (b) (1).

corporation, then the value is determined after full consideration of all of the factors set forth in Rev. Rul. 59-60.¹⁹²

With respect to other personal property, the valuation often becomes subject to the views of recognized experts in the particular field. Questions such as the fair market value of a work of art have been an audit question so frequently that the IRS created an Art Advisory Panel to assist in the administrative resolution of the problem.¹⁹³

Some of the questions as to value ultimately are resolved in litigation, and it is not surprising to observe that the courts usually settle on a value about midway between the taxpayer's expert's view and that of the IRS expert's opinion. The issue of value was also involved in former President Nixon's tax return where his expert, Ralph Newman, appraised a portion of Nixon's papers at over two million dollars.¹⁹⁴ Mr. Newman's expertise was also questioned in connection with the late Governor Otto Kerner's unsuccessful claim for a carry-forward charitable deduction.¹⁹⁵ In one extreme case, the appraisal of the value of a music manuscript given to the University of Wisconsin, or more precisely its over-valuation and actual date of transfer, was so gross as to result in a finding of criminal tax fraud against Skitch Henderson.¹⁹⁶ Generally, the most frequently litigated issue on valuation appears to be regarding gifts of art to colleges and universities.¹⁹⁷

192. Rev. Rul. 59-60, 1959-1 C.B. 237.

193. For a brief discussion of the purpose and operation of the IRS Art Advisory Panel, see O'Connell, *Defending Art Valuation for Tax Purposes*, 115 TRUSTS & ESTATES 604, 605 (1976).

194. Nixon's Tax Returns, *supra* note 172, at 74.

195. Otto Kerner, Jr., T. C. Memo 1976-12.

196. *United States v. Lyle C. Henderson*, 386 F. Supp. 1048, 1055 (S.D. N.Y. 1974).

197. See, e.g., Adolph Posner, T.C. Memo 1976-216; Edwin F. Gordon, T.C. Memo 1976-274.

In view of the many important questions as to the value of property and the critical date of its delivery, it behooves college representatives to retain records as to the date the property was received, and to refrain from volunteering views as to value.

While you may wish to encourage gifts of this nature, the many questions which may arise during a tax audit suggest that you would be doing your donor a service by requiring that he accept full responsibility for proving the value. In this way, the donor will probably obtain suitable expert appraisal and possibly accept the existential vicissitudes that may occur during the audit of his tax return. It is, of course, important that the college refrain from selling contributions of personal property or else there may be a reduction in its value to the donor since the IRS may question whether its use is related to the exempt purposes of the recipient charity.¹⁹⁸ In any event, in light of the complex issues involved, the college administrator should be careful not to involve the college in questionable activity through his or her actions or the actions of other associated personnel.

198. See text at notes 174-75 *supra*.

III. THE ROLE OF THE PRIVATE COLLEGE

It is important that private colleges, like other institutions, continually define their responsibilities in light of contemporary developments. The well-known stress caused by the growing demands of its employees are significantly changing the traditional administration of educational institutions. Of the many matters concerning the administration of a private college, four major considerations have been selected for discussion because of their relative importance and tax impact:

(1) endowment investment and the donor's directions; (2) providing tax advice; (3) alternative supplemental sources of revenue; and (4) providing services to staff, faculty and students.

A. Endowment Investments and the Donor's Directions

The various Attorneys General of the respective states are generally conceded to have all of the common law powers previously exercised by their historical predecessors, the English Attorneys General.¹⁹⁹ However, the common law rights are at best a vague tradition of several types of legal services carried on by the English predecessors. While most states have not clearly identified the powers now resting with the respective state's Attorney General,²⁰⁰ the majority of state courts concede that the traditional powers of that office include the authority to enforce charitable transfers.²⁰¹ The

199. The National Association of Attorneys General, *COMMON POWERS OF STATE ATTORNEYS GENERAL I* (report published by L.E.A.A. grant 1975).

200. The state of Ohio recently codified the additional powers of the Attorney General for supervising charitable trusts. OHIO REV. CODE ANN. § 109.24 (Supp. 1976).

201. REPORT OF THE OHIO ATTORNEY GENERAL, WILLIAM J. BROWN, TO THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS (FILER COMMISSION) 18 (Dec. 28, 1974).

present belief is that it is desirable to codify such powers to more efficiently supervise the delivery of the charitable trust in accordance with the donor's declared intentions.²⁰²

In terms of the endowments of private colleges, what kinds of records are kept and what reviews are conducted to insure that the donor's specific directions are carried out? It would be more than embarrassing for the college, and quite possibly detrimental to future contributions, if an action is filed by the state Attorney General alleging that the private college is not carrying out the donor's directions. How many of your trustees are aware of the specific restrictions that are attached to substantial contributions, particularly with respect to funds established years ago, and how should your trustees insure that the college does not apply the income from the endowments in a manner other than as directed by the original donor?

Occasionally, the donor's original directions as to a specific charitable purpose are not capable of being carried out. In that event, the courts generally enforce the charitable dedication direction by applying the doctrine of *cy pres* which requires that the donor's intention be carried out as closely as possible.²⁰³ In order for the doctrine of *cy pres* to apply, it is necessary to initiate an action in a court of general jurisdiction. In such actions, the attorney general for the state in which the trust is created must be involved in the judicial proceeding.

202. *Id.* at 23.

203. The traditional interpretation of the doctrine of *cy pres* is expressed as follows:

Where property is given in trust for a particular charitable purpose, the trust will not ordinarily fail even though it is impossible to carry out the particular purpose. In such a case the court will ordinarily direct that the property be applied to a similar charitable purpose. The theory is that the testator would have desired that the property be so applied if he had realized that it would be impossible to carry out the particular purpose.

4 A. SCOTT, THE LAW OF TRUSTS § 399, at 3084 (3d ed. 1967).

With respect to the investment of endowment funds, and liability in connection therewith, the present situation is undergoing a change. A uniform state statute has been drafted, dealing with the management and investment of endowment funds.²⁰⁴ The standard of liability for improper investment was originally based upon the prudent man rule adopted in the case of *Harvard College v. Amory*.²⁰⁵ In simplified terms, this meant that the investor had to consider not only the income return of the investment but also had to insure the protection of the corpus by not investing in high risk ventures. The result of the conservative prudent man rule, as applied by many treasurers of charitable institutions, was that:

During the late fifties and sixties, colleges, universities, hospitals, museums, and other charitable institutions became seriously pinched because endowment and other income failed to keep pace with rapidly increasing costs. The treasurers of many such institutions were able to point with pride to increasing endowments due to alumni and other public generosity and in many cases because of investment in so-called growth securities. Nevertheless, a portfolio balanced in accordance with traditional wisdom, yielded something in the nature of four percent. The more growth securities there were, the lower the yield tended to be. Although interest rates had climbed sharply during much of this period, monies so invested were promptly eroded by inflation. Thus, the institutional treasurer began to look longingly at the unrealized appreciation in his investment portfolio and to wonder if

204. UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS, HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 192 (1972).

205. 26 Mass. (9 Pick.) 446 (1830). For a detailed discussion of the case and its ramifications, see Friedman, *The Dynastic Trust*, 73 YALE L.J. 547, 552-555 (1964).

some of it could not properly be tapped for current needs.²⁰⁶

The purpose of the model statute is to free the institutional treasurers from the prudent man standard in favor of a reduced standard of "ordinary business care and prudence."²⁰⁷ The operative intent of the statute is to allow the application of both the fund's income and the appreciation in the value of the assets (the amount in excess of the value at the time of the contribution) to the general expenses of the charity without subjecting any person or organization to liability. Many representatives of charitable organizations believe that the ultimate effect of the new standard will be to require application of corpus appreciation to meet normal operational expenses. This would soon result in the full consumption of endowment funds which, if otherwise protected, offers some financial hedge as to the future. What is the position of your trustees and administrators as to the use of endowment funds for current operations and should you recommend opposing the proposed charitable management law? It is important for your college to give thorough consideration to these developments before they become a reality.

B. Tax Advice

An aggressive and highly competent development director is a vital part of every private college's plans for growth. Awareness of the tax rules and of specific tax devices which may be employed to provide substantial tax savings to possible donors should be part of the normal arsenal of weapons in your development director's pitch; but does he remember the line between "his" plan and the "donor's" plan? Active stimulation of the giving reflex does not mean that the development director or someone providing that service in your college becomes tax counsel to the donor.

206. Report of Committee on Charitable Giving, *The Uniform Management of Institutional Funds Act — A Commentary*, 8 REAL PROP., PROB. & TRUST J. 405 (1973).

207. *Id.* at 406.

Simply stated, there are too many complex problems for your college to assume that legal responsibility without proper guidance. It is possible that the result of a small defective plan initiated by the college's representatives could be the loss of a donor's goodwill toward your college as well as the future loss of additional contributions. The donor will not perceive the abstract distinction that the error was that of the development director and not that of the college; rather, it is most likely that he will be irritated at the college. Thus, *it is important to emphasize that the college representative should refuse to be the donor's legal counsel.*

With respect to pitches coming from donors, it is also important to properly refer them to the college's legal counsel before executing any agreements. There may be other legal issues, in addition to those affecting the college's tax-exempt status or creating unrelated trade or business income. Through the advice of competent counsel, the college's position can be best served and protected. This is not a plea for the employment of our law school graduates²⁰⁸ but rather a recommendation that you obtain the same protection which commercial corporations find to be absolutely necessary during this era of litigation.

C. Alternative Sources of Income

Recognizing that tuition tax credits, employer tuition plans and student loans are indirect sources of revenue for private colleges, most authorities agree that such combined approaches are now financially significant and will become increasingly important as tuition costs continue to rise.²⁰⁹ Scholarships and fellowships funded by non-educational institutions are also, in many respects, alternative sources of revenue but are considered more pertinent to the discussion

208. In lawyer words, this may not, in fact, be true.

209. See, e.g., Coughlin, "Colleges will Charge 8 Pct. More in Fall," The Chronicle of Higher Education, April 5, 1976, at 1, col. 2.

below concerning services to faculty, staff and students.²¹⁰ What is clear is that tuition tax credits, employer tuition plans, and student loans are not finding sufficient protection in the tax code. In fact, all three have been undergoing severe scrutiny during this past year.²¹¹ This alone should prompt the universities and colleges to act, for these sources of revenue enhance the student's economic ability to select a private institution of higher learning.

During its deliberations on H.R. 10612,²¹² the Senate Finance Committee identified some of the problems caused by the increased costs of education:

The cost of a college education has increased dramatically in recent years. The Committee is concerned about the *growing number of qualified students who are prevented from obtaining a higher education because of the increasing costs*. The escalating costs are making it increasingly difficult

210. See text at notes 229-235 *infra*.

211. For example, interim regulations governing the National Direct Student Loan Program have been adopted by the Office of Education. Reflecting the changes made by the Education Amendments of 1976, these interim rules are intended to improve the administration of the program. Some of the new regulations which clearly demonstrate the concern about the poor repayment rates of the student loans are as follows:

(1) Institutions with delinquency rates above 10% may have their funding requests cut unless the high rate is satisfactorily explained.

(2) Institutions, in collecting loans, may be required to use commercial collection agencies.

(3) Institutions will be required to submit semi-annual default reports and have their loan funds audited at least once every two years.

For an official record of these regulations, see 41 Fed. Reg. 51945 (Nov. 24, 1976).

212. This House bill was ultimately adopted as the Tax Reform Act of 1976.

for many parents to provide their dependents with a higher education. The impact of rising college education costs has been particularly hard on middle-income families. Low-income families are eligible for various government programs providing direct grants, work-study programs, and guaranteed or low interest loans, while high-income families are generally able to afford college expenses. The Committee believes that tax assistance is necessary to help assure a greater access to higher education.²¹³

As a result, the Finance Committee recommended a tax credit for the principal benefit of middle-class families. In addressing the debate on the Senate floor, Senator Ribicoff, noting that the tuition credit had passed the Senate on three prior occasions but had never survived the House of Representatives, remarked that "[w]e are investing in our country's future by allowing this tax credit, just as we invest in our future when we allow industry an investment tax credit."²¹⁴ Notwithstanding the merits of a tuition credit, the Conference Committee deleted the Senate amendment.²¹⁵

Other financial sources for higher education have not received favorable treatment. The IRS recently removed the tax advantages of the corporate educational trust which is designed to pay for college expenses of the corporate

213. S. Rep. No. 94-938, 9A U.S. Code Cong. & Adm. News 543, 1135 (1976) (emphasis added).

214. 122 Cong. Rec. 13,567 (daily ed. Aug. 5, 1976). The Senate rejected an amendment to extend the tax credit to private primary and secondary schools by a vote of 52-37. *Id.* at 13,565.

215. H.R. Rep. No. 94-1515, 9A U.S. Code Cong. & Adm. News 1222, 1338 (1976). However, the Conference Committee agreed that "every effort will be made to give the House of Representatives an opportunity to consider this provision in separate legislation." *Id.* It has been reported that a tuition tax credit amendment will be made to H.R. 1369 dealing with a special relief provision for the benefit of Smith College. 39 U.S. TAX WEEK 1165 (1976).

employees' children.²¹⁶ The effect of this position is to defer the corporate deduction until the child becomes a candidate for a degree, but at that time the parent must report the amounts distributed as additional income.²¹⁷ While the Commissioner has terminated the tax benefits of these particular educational funds, this position should be compared to the recently enacted law providing precisely the same benefit for employer contributions to qualified prepaid legal service plans.²¹⁸ The employer is able to obtain an immediate deduction for contributions to the legal service plans while the employee does *not* have to report as additional income the fair market value of the legal services when provided. *This contrast points out the importance of being represented both in Congress and before the IRS.*

When considering alternative sources of revenue, one must recognize the very important role that the government guaranteed loans, as well as the veteran educational benefits,²¹⁹ have played in providing aid to students pursuing study at

216. Rev. Rul. 75-448, also released as T.I.R. 1406 (Sept. 24, 1975). The IRS takes the position the corporation is not entitled to a deduction for contributions to the trust until the child becomes a candidate for a degree. At that time the right to benefit vests, and the parent must report the college expense distribution as additional income. Cf. Rev. Rul. 76-352, 1976-38 I.R.B. 7, where tuition payments may be a pass through if they are otherwise deductible educational expenses in accordance with the requirements of Treas. Reg. § 1.162-5. For a recent article dealing with the potential of such employer-educational funds, see Cleave, *The Educational Benefit Trust: Loophole or Sinkhole?*, 29 VAND. L. REV. 807 (1976).

217. A taxpayer unsuccessfully attempted to enjoin the Commissioner from issuing that ruling. *Educo v. Commissioner*, F. Supp. , 38 AFTR 2d 76-5070 (N.D. Ill. 1976).

218. See § 2134 of the Tax Reform Act of 1976, P.L. 94-455, adding I.R.C. §§ 120 and 501 (c) (20).

219. The Senate Veterans' Affairs Committee stated that:

Educational assistance to facilitate a veteran's readjustment to civilian life has been part of American life for 32 years. Over 16.3 million veterans, almost 8 percent of the entire population of the United States, have received

institutions of higher learning. The veteran educational benefits directly relate to accepted moral and financial obligations of the government to assist in the readjustment of former service personnel into civilian life. What is often forgotten in regards to veteran educational benefit programs is that such payments to veterans are specifically excluded from income taxation.²²⁰ As international conflict or the threat of it decreases, this type of governmental support will of course decrease.²²¹

The veterans educational benefits programs should be contrasted to the government guaranteed student loan programs which are geared to providing general financial assistance to all students who seek higher education. The government guaranteed student loan issue is very complex;²²²

educational assistance under the GI bill since 1944. This includes 7.8 million under the World War II GI bill, nearly 2.4 million under the Korean conflict GI bill and more than 6.1 million trainees under the current GI bill.

S. Rep. No. 94-1243, 94th Cong., 2d Sess. 26, 12 U.S. Code Cong. and Adm. News 5667, 5674 (1976).

220. 38 U.S.C. § 3101 (a); Rev. Rul. 71-536, 1971-2 C.B. 78. Under several recent revenue rulings, military service funded scholarships are excludable from the income tax under I.R.C. § 117. *E.g.*, Rev. Rul. 76-519, 1976-52 I.R.B. 15; Rev. Rul. 76-518, 1976-52 I.R.B. 14; Rev. Rul. 76-517, 1976-52 I.R.B. 14. These rulings are based upon a special provision in the Tax Reform Act of 1976 which extended the exemption period. Section 2130 of the Tax Reform Act of 1976, P.L. 94-455.

221. Congress has already reduced the educational benefits for post-Vietnam era veterans. *See* S. Rep. No. 94-1243, 94th Cong., 2d Sess. 60, 12 U.S. Code Cong. and Adm. News 5667, 5708 (1976). Without a complete historical analysis of the veteran educational benefit programs, the author would not be surprised to find that private colleges have not effectively communicated to Congress the importance of these types of programs, and this has resulted in a subtle but substantial erosion in the benefits.

For a historical background of the veterans educational benefit programs, *see* H.R. Rep. No. 1258, 89th Cong., 2d Sess. (1966), 2 U.S. Code Cong. & Adm. News 1888, 1888-90 (1966).

222. Winkler, "The Long Arm of Washington's Basic Opportunity Grants," *The Chronicle of Higher Education*, Oct. 25, 1976, at 3, col. 1.

one of the more gruesome factors is the relatively poor repayment situation which is very puzzling to Congress.²²³ Colleges should assume more responsibility in developing a more effective repayment procedure if they desire the continuation of such programs.

The broad consideration of alternative sources of revenue inevitably invites comparison to direct grant programs. While an analysis of direct grants by the state and federal governments is not within the scope of this article, there is no question as to the major importance of such financial assistance to private colleges. The direct subsidy programs are often replete with bureaucratic controls and, in certain situations, are offensive to the integrity of many private college administrators.²²⁴

Direct subsidy programs also raise constitutional questions regarding direct state or federal financial assistance to religiously affiliated institutions of higher learning. Because a number of state legislatures have insisted on thinly disguised aid to elementary and secondary parochial schools,²²⁵ the same constitutional arguments have been applied to private religiously affiliated colleges. For example, in *Roemer v.*

223. "Many Students Avoiding Payment of Loans by Filing for Bankruptcy," *The New York Times*, No. 21, 1976, at 1. col. 4. The Office of Education has attempted to remedy this situation. See note 211 *supra*.

224. Magarrel, "Freedom of Education: A Constitutional Right?" *The Chronicle of Higher Education*, Oct. 25, 1976, at 8, col. 1. The plight of Hillsdale College recently received nationwide publicity.

225. See *Committee for Public Education and Religious Liberty v. Nyquist*, 413 U.S. 756 (1973); *Grit v. Wolman*, 413 U.S. 901 (1973). These decisions tended to defeat the political apparatus which was operating to provide a federal tax credit for the tuition cost of attending private primary and secondary schools. See *Hearings before the Committee on Ways and Means on H.R. 16141 and Other Pending Proposals*, 3 Parts, 92nd Cong., 2nd Sess., Aug. 14, 15, 16, 17, 18; Sept. 5, 6 and 7 (1972) (relating to aid to primary and secondary education in the form of tax credits and/or deductions).

Board of Public Works of Maryland,²²⁶ the Supreme Court found that Maryland state grants to religiously affiliated private colleges did not violate the First Amendment prohibition against the establishment of religion.²²⁷

Aside from the constitutional issues, the principal difficulty of direct grant programs involves the concomitant evil of state or federal control. The present governmental encroachments on private colleges are already so severe that any further extension will be completely unacceptable to some and will likely invite a hostile response from most private colleges. With respect to indirect sources of income, private colleges must realize that such aid (tuition tax credits, scholarships, and student loans) tremendously enhances the student's ability to select a private college. These sources of income should be contrasted to direct governmental grants which are more likely to favor public institutions of higher learning.

Unfortunately, the college tuition credits have yet to become a reality. The issue is in need of effective support in the House of Representatives. As for employer educational trust funds, the IRS needs to hear from the colleges; and, if that fails, prompt consideration should be given to encouraging legislative action to provide a defined legal basis for such plans. The continuation of government guaranteed school loans is in danger for obvious reasons. It is imperative that educational institutions develop political support for these and other alternative sources of revenue.

To assist in renewing or developing support for alternative sources of revenue through the tax code, you should be aware of the tax expenditures concept and the views of several tax authorities who wish to remove to the fullest extent possible all

226. 96 S. Ct. 2337 (1976). The same issue was previously addressed in connection with a federal subsidy. *Tilton v. Richardson*, 403 U.S. 602 (1971).

227. 96 S. Ct. at 2349-50.

subsidies of that nature. In many respects, Professor Surrey is the leading spokesman for this position. In realistically identifying the various tax benefits to colleges which are provided through § 170 and other parts of the Internal Revenue Code, Professor Surrey commented that:

When "philanthropic logic" as seen by the colleges and others is thus so contrary to "tax logic," an instability exists. The tax reformers will attempt to chip away at the inequities in order to remove the tax illogic. The philanthropic institutions, having a vested interest in preserving an unfair and inequitable system, must defend existing abuses and inequities and oppose their correction — they must defend the exemption of the appreciation element in the gifts, must oppose allocations of deduction, must keep a watchful eye on the unlimited deduction for charitable contributions for estate and gift taxes, and so on. College presidents must appear before congressional committees and sit in senators' anterooms as lobbyists alongside the oil executives, oil investors, the lobby farmers, and the real estate operators — all pressing their claims that the special provisions of the tax option applicable to their activities should not be changed and contending that the national interest will be adversely affected by any change. One wonders whether college presidents relish the role or comprehend that many legislators and government officials believe that some of the presidents are not even aware of the role itself.²²⁸

228. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352, 389-90 (1970). Professor Surrey also perceptively stated:

It is thus clear that our colleges, insofar as such support through 'gift' is concerned, are really receiving nearly all of the support from the government with the 'donors'

There is much wisdom in Professor Surrey's perceptive observations as to both the irrational results of the many tax expenditures, including the charitable deduction, and the misunderstood role of private college representatives in discussing tax policy. Thus, one critical question for private colleges is simply whether it would be preferable to repeal all of the tax subsidies and alternatively seek direct economic assistance or to continue seeking further expansion of the hidden tax subsidies. If you select the latter, there is no reason that the private college representatives should fail to comprehend the broad range of social and economic results flowing from that decision. By such a choice, private colleges are seeking to secure their personal and economic interest in tax laws irrespective of other factors, such as ultimate government costs, tax complexity or consideration of a rational distribution of available assets.

D. Service to Staff, Faculty and Students

A private college's interests should include those of its staff, faculty and students. The failure to effectively represent or to provide efficient personal service to those important participants will interfere with the developing quality of the educational environment, which is, in many respects, the primary objective of private colleges. Consistent with the erosion of alternative sources of revenue, it is not surprising to observe similar deficiencies in the tax benefits flowing to these educational participants. In fact, it is here that the tax benefit rules have reached the bottom line. A brief review of current developments relating to scholarships for students, tuition remission programs for relatives of staff or faculty, and the deductibility of home office expenses clearly demonstrates an educational catastrophe of substantial proportions.

The specific exclusion from taxation for scholarships and

providing very little of their own funds and instead 'voting' through the deduction these appropriations of government funds to colleges.

Id. at 388-389.

fellowships has been almost repealed through the IRS's successful extension of the holding in *Johnson v. Bingler*.²²⁹ The facts in that case involved ongoing salary payments to employees who were on "educational" leaves of absence while working toward a doctoral degree. As part of the educational policy, the commercial corporate employers required that such employees return for full-time service after completion of their educational study; thus a clear *quid pro quo* existed for the continued payment of their salary during their leave of absence and therefore the exclusion was denied.

As a result of the *Johnson* case, the IRS will argue that even the slightest scintilla of a promise to work in the future is sufficient to defeat the exclusion of scholarship funds.²³⁰ Thus, many students, unaware that their scholarship benefit does not qualify for exclusion from tax, find out during a period of limited income that they owe back taxes, interest and possibly penalties.²³¹

In the House Ways and Means Committee report on H.R. 10612, attention was called to the issue of scholarships when the Committee report stated, under the brief discussion of areas for future study, that "with the assistance of the Internal Revenue Service, the Committee also will study the tax treatment of scholarships and fellowships, including student loans that are forgiven."²³² Similarly, the Senate Finance Committee expressed deep concern about the taxation of scholarships in its review of H.R. 10612. Pending study of the entire subject of scholarships, the Committee recommended

229. 394 U.S. 741 (1969). See *Parr v. United States*, 469 F.2d 1152 (5th Cir. 1972).

230. Rev. Rul. 73-256, 1973-1 C.B. 56.

231. Have private colleges allocated sufficient resources for devising their scholarship grants, with the advice of tax counsel, to avoid taxation or for informing students, before disbursement of the likely income taxation of their particular scholarship grants? It is doubtful that many colleges provide such services or, if so, to the extent necessary.

232. H.R. Rep. No. 94-658, 9A U.S. Code Cong. & Adm. News 1, 427 (1976).

revocation of Rev. Rul. 73-256,²³³ which held a physician taxable to the extent that a scholarship loan was forgiven for practicing medicine in a rural area.²³⁴ The conference report on H.R. 10612 accepted the Senate Finance Committee's amendment.²³⁵ With Congress returning to examine many facets of the exclusion for certain types of scholarship grants and, hopefully, a *de novo* review of *Johnson*, what are private colleges doing to develop information for persuading Congress to adopt favorable legislation? There are two important reasons for the private colleges' interest. First, scholarships funded by private individuals and institutions are indirect sources of income for meeting the increasing costs of operation. Secondly, students are an essential ingredient of educational institutions and their interests should be well represented in the halls of Congress.

Although there is some legislative chance of resuscitating the original tax exclusionary spirit of scholarships, the deduction for home offices of educators has been terminated by the passage of the Tax Reform Act of 1976.²³⁶ The home office issue was a tax benefit which was quite frequently claimed by faculty although not always allowed.²³⁷ It is now, so to speak, "gone with the wind."

The final blow in the area of tax assistance for staff and faculty appears to be the proposed termination of the tax-free fringe benefit of tuition remission generally available for the immediate family of staff and faculty. In recently proposed

233. Rev. Rul. 73-256, 1973-1 C.B. 56.

234. S. Rep. No. 94-938, 9A U.S. Code Cong. & Adm. News 543, 963 (1976).

235. H.R. Conf. Rep. No. 94-1515, 9A U.S. Code Cong. & Adm. News 1222, 1308 (1976).

236. See § 602 of the Tax Reform Act of 1976, P.L. 94-455, creating I.R.C. § 280A.

237. See, e.g., *Gino v. United States*, ___ F.2d ___, 38 AFTR 2d par. 76-5096 (9th Cir. 1976); Ahmed F. Habeeb, 1976 T.C. Memo 259.

Treasury regulations, the IRS has taken the position that such tuition remission benefits are taxable income to the employee.²³⁸ Fortunately this new position has elicited a loud outburst from many faculty members and educational associations.²³⁹ This is the type of tax issue which strikes at the hearts of many persons employed by educational institutions and which has an obvious direct impact on such person's "net" income as well as increasing operating costs to the private college if they continue such a tuition policy.

As a matter of logic, the approach of the IRS in taxing tuition free or reduced benefits clearly falls within the range of taxable benefits.²⁴⁰ It will be interesting to follow this controversy to ascertain the effectiveness of colleges and educational associations in challenging the IRS on this proposed position. Clearly, if the educators are not successful in reversing this position when there are so many persons directly affected, what hope is there in other areas of taxation which are both more complex and have only an indirect impact.

The unexpected decision of Treasury Secretary William E. Simon to withdraw regulations which would have imposed a tax on many fringe benefits provided to employees of commercial enterprises, seriously undercuts the IRS position in regard to the taxation of tuition remissions.²⁴¹ Secretary

238. Proposed Treas. Regs. §§ 1.117-3 and 1.117-4, 41 Fed. Reg. 212 (Nov. 2, 1976).

239. See, e.g., "Tax on Tuition Plan Assailed," The [Toledo] Blade, January 4, 1977, at 3, col. 3; "Proposal to Tax Faculty Members for Free Tuition Draws Criticism," The New York Times, Dec. 5, 1976, at 86, col. 1.

240. For those who heard the author's speech, you may recall that the opinion was expressed that it was doubtful that this particular tax-free fringe benefit would survive much longer without IRS attack. See Item IV, E. 5 of speech outline, dated Oct. 21, 1976.

241. Treas. News Release, dated December 17, 1976. This does not mean that fringe benefits will not be subject to taxation as a matter of law, but as a matter of practice it suggests that revenue agents will raise the

Simon's decision to terminate future efforts to clarify the taxation of fringe benefits through Treasury regulations or rulings was preceded by an orchestrated barrage of phone calls from angry airline employees who would have been taxed on the value of their traveling privileges.²⁴² The prompt reversal of the official position augurs well if similar pressure is brought to bear on the taxation of the tuition remission.²⁴³

There are many other services that a private college should consider which involve taxes. For example, what kind of assistance does your college provide to a visiting professor? Such a person faces a number of important tax questions, e.g., whether he can deduct cost of moving or the cost of living temporarily at the new place of employment, and if he may depreciate his home located at his prior place of employment.²⁴⁴ What types of pension plans, tax-deferred annuity or similar benefit plans exist at your college and how well, if at all,

question only where the value of the fringe benefit is not insignificant and available only to a few employees.

242. Rowe, "Callers Besiege Treasury Over Tax Shift Possibility," *Washington Post*, Dec. 10, 1976, at 5, col. 2.

243. See Rowe, "Treasury Scraps Plan to Tax Certain Fringe Benefits," *Washington Post*, December 18, 1976, at 5, col. 3, reporting that "[y]esterday's action by Simon does not affect a proposed rule issued by the IRS which would tax tuition benefits provided by universities and colleges to the families of their employees." As explained by Mr. Rowe, there seems to be some policy differences between the Treasury and the IRS on the taxation of fringe benefits. The new Carter Administration will likely have the final word on the taxation of tuition remission, subject to judicial review if necessary.

The basic position of this paper, i.e., effective communication with both federal and state government on specific issues, is demonstrated by the vehement reaction of representatives of higher education against the proposed Treasury regulations taxing the value of tuition remission. See note 239 *supra* and accompanying text. This article went to press coincident with the withdrawal of the tuition regulations, IRS News Release IR-1735 (Jan. 13, 1977), pending a comprehensive study of scholarships by Congress. See note 232 *supra* and accompanying text.

244. For a discussion of some of these questions, see Hasselback, *Tax Implications of a Visiting Professorship*, 52 TAXES 499 (1974).

are such programs explained to staff and faculty? Too many colleges have developed the view that personal business planning matters of its employees are beyond its responsibility. This tradition has been changing but not fast enough. A few outdated pamphlets explaining programs which have been modified does not meet this responsibility.

In sum, the scholarship situation is weak, the home office deduction has passed into "loophole heaven," and the tuition remission programs are locked in fierce battle and under serious attack. With respect to other services, the colleges reluctantly provide some basic assistance but not enough.

CONCLUSION

It was the objective of this overview to bring you into a closer and more personal understanding of the federal tax system and its impact on the operation and growth of private colleges. The Filer Commission Report seductively awaits exploitation and expansion by private colleges and educational associations. It is a beginning. Hopefully, some of the provocative statements made therein will challenge you to achieve a more effective utilization of an important private college economic asset—the Internal Revenue Code.

The relationship between individual colleges and the educational associations located in Washington, D.C. needs further development at both ends. Often, there is a subtle but insidious problem inherent in national representation. The difficulty involves interrelated negative contributions from both the private colleges and technical staff of national educational associations. If the private colleges and its administrators fail to become personally involved and fail to understand the interrelated complexities, this will be ultimately reflected in the enthusiasm, or lack thereof, by the technical experts of the educational associations in their efforts and presentations to Congress. If there is substantial comprehension of the technical reports along with challenging questions, this will result in direct personal involvement and will ultimately contribute to the effectiveness of Washington based technical staff.

It is not unusual for staffs of educational associations or other national organizations to seek peaceful isolation, far removed from the intense emotional concerns of the grass roots. The Washington-based educational staff understands the Filer Commission Report; they recognize the tax code as an economic asset, but have they stimulated your thinking and are they preparing for creative and informative presentations to Congress? It is that group which must convert the importance of private education as a social and political value into specific positions which will be adopted by Congress.

In fact, the initial barrier to effecting change may call for reassessment of the staff of various national educational associations.²⁴⁵ In the words of Meredith Wilson's "The Music Man," does the staff tend to defend or explain reasons why a particular position cannot be changed and does the staff tend to respond by discussing their personal relationship with key legislators and indicate on the basis of "very private" communications why they believe Item X will soon be law? If so, then you have trouble! Positions on specific issues which are enacted into law for long periods are generally thoroughly debated and tested before congressional passage; this should be compared with the usually limited life of covert special interest legislation.

Spurred by your efforts, knowledge, and enthusiasm, the peaceful isolation of the Washington staff can be replaced by aggressive and creative representatives. With the development of rational positions that provide, directly or indirectly, economic assistance without the concomitant evil of control, the chances for survival of the private colleges will correspondingly increase with the quality of such positions and the effectiveness of such representation.

If you will observe what a well-organized farm community did to the estate and gift tax laws last year,²⁴⁶ there is no

245. In fact, the staff aspect as well as some difference in goals between public and private institutions of higher learning has raised the importance of private institutions having a "voice" of their own. See Scully, "Private Colleges Urged to Establish Their Own Lobby," *The Chronicle of Higher Education*, Jan. 26, 1976, at 3, col. 1. The task force report of the American Association of Colleges was accepted and a new organization, National Association of Independent Colleges and Universities, was created to represent such private institutions. See "AAC Approves New Lobby for Private Colleges," *The Chronicle of Higher Education*, February 17, 1976, at 6, col. 1.

246. The first significant tax reform in the area of estate and gift tax statutes was due primarily to a well-organized farm lobby which made both personal and "technical" reports to Congress. See Public Hearings and Panel Discussions before the House Committee on Ways and Means, 94th Cong., 2nd Sess., Parts 1 and 2 (1976).

question that a similar achievement can be attained to secure the permanent place of private colleges without the erosion of their unique ingredients. However, this can only occur if private colleges and educational associations effectively crystallize their discussions of danger into specific positions which are understood, accepted and supported by the country. Without that coordinated effort, we will likely see the downfall of private education, as we have known it, except for the few well endowed institutions of higher learning.

While there exists increasing competition between public and private institutions of higher learning for private and governmental funds, both educational institutions equally share in the benefits of further utilizing the tax code as an economic asset. *As such, the situation demands reconciliation and combined allocation of resources for the ultimate achievement of education, both public and private, as a secured social value of our country.*

* * * *

The purpose of this paper has been to identify those areas of the Internal Revenue Code which offer disguised but real financial support for private colleges. Further expansion of its potential economic value awaits your creative efforts. Without your action, you can expect only further erosion of the present educational tax benefits. If, as some experts desire, Congress decides to repeal most of the tax incentives (tax expenditures), including the charitable deduction, in favor of direct subsidies with accompanying regulation and bureaucracies, this will have a drastic effect on your future growth. It is obviously extremely important for private colleges to fully explore the alternative before it is too late.²⁴⁷

247. The major question regarding the expansion or repeal of tax subsidies (legislatively classified as tax expenditures) to educational institutions is dependant upon a comprehensive analysis of each subsidy in terms of its cost, complexities, efficiency, equity and results. The principal statement of the proponents as to the purpose, utility and legislative acceptance of the tax expenditures concept is set forth in Surrey and McDaniel, *The Tax Expenditure Concept and The Budget Reform Act*

Within the next decade we will see whether private colleges can effectively organize, and not only identify the important economic issues affecting their future, but also deliver the necessary political support to secure their future. The tax structure is but one aspect of the many issues concerning private colleges. It is unique in that it offers maximum economic benefits with minimal governmental control. This is a rather key feature during the modern era of ubiquitous governmental intrusion.

For me, this has been a delightful *deja vu* experience. I will be studying the results of your success or failure in future tax laws relating to education. This article is written in hopes of assisting your efforts for future success.

of 1974, 17 B.C. IND. & COM. L. REV. 679 (1976). While one may question the scientific and definitional validity of the tax expenditures concept, *id.* at 687-88, it must be admitted that it is, for the present, an aspect of every statutory tax revision which must be considered. If it is merely a tool for an ideological purification of the Code, then Congress will not long be impressed with its utility.

In regard to those tax expenditures that benefit education, one author concluded:

The euphony of the tax theologian in search of equity may well be abstractly pleasing but destruction and injury to colleges and universities, even if conducted in the name of populism or anti-elitism, would be devastating to the quality of national life. Our system of higher education has flourished in an atmosphere where tax laws lend encouragement to charitable giving and the costs to this system would greatly exceed any benefits which would be achieved for our tax system should this atmosphere be made hostile to charitable gifts.

Levi, *Financing Education and the Effect of the Tax Laws*, 39 LAW & CONTEMP. PROB. 75, 116 (1975). Compare this to the statement of two others authorities:

In general, tax incentives enter an analysis with one strike against them — the prodigious indictment issued by Professor Surrey. The tax incentives for higher education suffer from additional specific defects that make their inclusion in a system of federal policy instruments undesirable. In the first place, where they are designed to serve social goals, they further the less important ones. Where they provide subsidies, they often provide larger ones higher income taxpayers Second, the current tax incentives are only

marginally effective. They result in sizeable tax revenue losses while stimulating only small changes in private behaviors. In some instances, their net impacts may actually be negative. Third, the efficiency of these policy instruments is even more doubtful. Not only is it easier to design expenditure programs the resource flows of which are more appropriate and effective, such expenditure programs are generally both authorized and operational.

Kirkwood & Mundel, *The Role of Tax Policy in Federal Support for Higher Education*, 39 LAW & CONTEMP. PROB. 117, 154 (1975).